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FEDERAL INCOME TAX

INCLUDING ALSO

War Profits, Excess Profits, Stamp, Capital Stock and Child Labor Taxes

BY

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1922 Edition

INDIANAPOLIS
THE BOBBS-MERRILL COMPANY
PUBLISHERS

T
H7355f
1922

Bookwalter-Ball-Greathouse
Printing Company
Indianapolis

PREFACE

Much of the criticism leveled at the Revenue Act of 1918 was inspired by the high tax rates. The inequalities and shortcomings of the Act were brought into high relief because of the heavy tax burden resulting therefrom. As compared with any previous law, however, the Revenue Act of 1918 was a clear, definite, comprehensive and equitable tax statute. Credit should be given for the insight and prevision which dictated the general scheme of the law and devised the remedial provisions of the Act which have saved many a taxpayer from hardship and disaster. Several of the new provisions contained in the Revenue Act of 1921 are a further step in the same direction.

The most violent criticism of the Revenue Act of 1918 was directed against the war-profits and excess-profits taxes—necessary evils brought about by the financial exigencies of the closing year of the war. The repeal of these taxes has been advocated by many public bodies and by two Secretaries of the Treasury. Nevertheless, Congress saw fit to continue the excess-profits tax for the year 1921, an action the wisdom or unwisdom of which will be shown by the statistics of revenue receipts for the past year.

Except for the repeal of the excess-profits tax law, the Revenue Act of 1921 is in large part a re-enactment of the 1918 Law. It follows closely the structure and arrangement of that law, as may be seen from the fact that in general the section numbering of the former statute is preserved in the new one—a considerable aid to those who must become familiar with the new law. Yet many changes have been made and many new provisions introduced. Some provisions are merely nominal amendments, others are a statutory recognition of departmental regulations and practice, or are founded upon recent court decisions or constitutional doubts as to previous statutory provisions and regulations. Some modifications are directed against possible evasion of tax. Other changes, and perhaps the most important, are remedial in their nature, chief among which are those which release capital transactions from the inhibitions heretofore imposed by unwise taxation. Many provisions recognize the disturbed business conditions confronting the country in this post-war period. The whole statute reflects the valuable experience gained, both

by the Treasury Department and taxpayer, in dealing with problems of taxation during the past five years.

The new statute is not a simple one, nor can a simple statute be devised to cover so complex a subject as income taxation applied to all the varied activities of a great nation like ours. It is, however, another great step forward in the development of our system of income taxation. Few taxpayers are aware of the hard and unceasing work to this end that has been done by many able and public-spirited men. Of these Dr. T. S. Adams is a notable example. To his untiring efforts as special adviser to the Treasury Department may be ascribed many of the improvements in the law.

Unfortunately, every new law creates new problems of interpretation and application. Years of experience with the 1918 Law were beginning to familiarize both government and taxpayer with its more obscure provisions; the meaning of that law was becoming constantly more settled and certain; and many of its complexities were being simplified in the daily round of administration. Much of the ambiguity and obscurity of the new law can be clarified only as concrete problems are presented in the administration of the law. Much of it is apparent now and will be resolved, it is to be hoped, by a liberal interpretative attitude on the part of the Treasury Department, having due regard, wherever possible, to the spirit as well as the strict letter of the statute.

It is to be remembered, however, that the Treasury Department is not a judicial body—the purpose of its existence is to collect revenue. Its rulings may work hardship on occasion, but frequently such rulings are inevitable under the statute from which alone the department derives authority to make regulations. The ultimate remedy in such cases is to improve the statute by amendment—a matter to which the taxpayer gives too little thoughtful attention. Moreover, the first and general rulings must construe the law more narrowly than the construction which may be possible in specific cases. If a broad construction were indulged in generally, no taxpayer would ever call attention to the cases in which revenue was allowed to escape. This does not mean that a taxpayer is deprived of the right to protest when he feels that the administration of the law operates unfairly in his particular case. The present statute is more explicit than any previous law in making provision that he may do so. This is perhaps the only practicable method by which the conscientious taxpayer may avoid being penalized by

rulings, the general purpose of which is to prevent the evasion of taxes by citizens who will not scruple to evade taxes by every means at their disposal.

One of the most difficult problems confronting us in this critical period of readjustment is presented by the fact that the settlement of tax cases has lagged so far behind. Many substantial 1917 taxes remain undetermined, and taxes for 1918, 1919 and 1920 are in the year 1922 an unknown quantity in thousands of cases. This is said in no critical spirit; it has been to a large extent unavoidable, when the true magnitude of the task imposed on the Treasury Department is considered. Indeed, the confusion and uncertainty might have been far worse—and even irremediable—but for the skill with which the 1918 Law was drafted and the painstaking attitude and conscientious manner with which the task of interpretation and administration has been approached and handled. But the fact remains that thousands of cases arising under previous statutes remain unsettled, and the permanent and final readjustment of the business affairs of the country is hampered by delay in the audit of returns under these preceding laws and the settlement of back taxes.

The purpose of this volume is to facilitate the early determination of cases arising under preceding laws, as well as to assist to an understanding of the statute which has just been passed, and pursuant to which returns for the year 1921 must soon be filed. No adequate understanding of this new statute may be had independently of the statute it replaced, and even where the discussion in this volume is confined to the provisions of the 1918 or preceding laws, or the regulations issued thereunder, it is believed that light will be thrown upon the meaning of the present law by such a revelation of the evil intended to be corrected by a given provision of the present law and by the history, development and evolution of doubtful provisions.

Although this volume discusses many rulings issued under the present law, it does not contain the new regulations (corresponding to Regulations 45) presently to be issued. This is impossible if the volume is to be available early in 1922. The attempt is made, however, to indicate throughout the book the respects in which the rulings and regulations issued under the 1918 Law will necessarily be modified, as well as the rulings and regulations issued under that law which ought to be substantially re-enacted. Many references to and quotations from Congressional Committee reports, throwing light on the interpretation of the new law, will also be found. All decisions contained in

the weekly Treasury Bulletins issued in 1921 through number 49 have been included in this volume, unless in the opinion of the author they contribute nothing to the solution of any question other than the one involved. These Treasury Bulletins are referred to by the abbreviation "T. B." References to the Bulletins also indicate the nature of the decision cited by the same abbreviations used in the Bulletins, which are as follows: "A. R. M." (Committee on Appeals and Review Memorandum), "A. R. R." (Committee on Appeals and Review Recommendation), "Mim." (Mimeograph Letter), "O." or "L. O." (Solicitor's Law Opinion), "O. D." (Office Decision), "Op. A. G." (Opinion of Attorney-General), "S." (Solicitor's Memorandum), "Sol. Op." (Solicitor's Opinion), "T. B. M." (Advisory Tax Board Memorandum), "T. B. R." (Advisory Tax Board Recommendation) and "T. D." (Treasury Decision). The Income Tax Service and the War Tax Service issued by the Corporation Trust Company of New York have again been referred to as sources of information. Where possible, reference has been to the latest of such services. The services are so widely known and so generally recognized that no explanation need be given for their use. They are cited "I. T. S." and "W. T. S.," respectively, in the footnotes.

The author has had the pleasure of association with many officials, collectors, and inspectors of the Treasury Department, and has found them, with rare exceptions, intelligent, fair minded and just in their dealings with the taxpayer. Differences of opinion as to the application, effect and interpretation of the law have necessarily arisen, and in such cases the Treasury Department has uniformly stood ready to afford the taxpayer full opportunity to express his views and arguments. Where agreement with such views and arguments has not been possible, it has been because such officials have felt themselves bound by their understanding of the law, even though they might recognize the justice of the taxpayer's contentions. In his association with such officials the author has observed on their part a sincere interest in the development and improvement of administrative rulings, which are scarcely less important than the statute itself. For this reason the author has frequently commented upon various rulings and regulations in instances when his opinion differs from that expressed in a given ruling or regulation. This comment is intended as constructive criticism, in the hope that it may contribute to the difficult task of interpretation and administration. Criticisms on the shortcomings of this book and suggestions for its improvement will be gratefully received.

The author's thanks are again extended to the many friends who have given him helpful suggestions and criticisms, particularly to Mr. Harrison B. Spaulding, to Mr. Randolph E. Paul, of the New York and New Jersey bars, and to Mr. Valentine B. Havens, of the New York bar, for their assistance in preparing the manuscript. The assistance of Mr. John F. McCarthy, of the New York Law Institute, in checking citations is also gratefully acknowledged.

George E. Holmes.

New York, January 2, 1922.

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FEDERAL INCOME TAX

CHAPTER I

INTRODUCTION [1]

The Federal Income Tax is now imposed by Title II and the Excess-Profits Tax by Title III of the Revenue Act of 1921.[2] This act (referred to in this book as the Revenue Act of 1921, the 1921 Law, or the present law) became a law on November 23, 1921, but the income tax and the excess-profits tax titles, as well as certain other specified parts of the statutes, are made effective as of January 1, 1921. The Revenue Act of 1921 follows the general scheme of the comprehensive Revenue Act of 1918.

That act was, of course, a war measure, introduced into Congress while the war was still in progress, and passed during the period of the government's maximum need of revenue. Many of its provisions were a direct result of economic and other conditions caused by the war and others were enacted with probable post-war conditions in mind. The need of revenue is still tremendous after more than three years of peace, and the taxpayer's burden under the new law will still be heavy. The normal tax rates for individuals remain the same as under the 1918 Law. The surtax rates are not changed for 1921, but for 1922 and succeeding years the maximum surtax rate is 50% and some relief is also provided by the lower rates. For the year 1921, corporations are taxed at the same rates as formerly, both under the income and excess-profits tax laws. For 1922 and succeeding years, the income tax on corporations is increased from 10% to 12½%, but the excess-profits tax is repealed. In addition to the reduction in rates the law is less rigorous in several other respects. In this regard, the most notable remedial changes made by the 1921 Law are those relating to exchanges of property, including reorganizations and transfers of property

[1] The purpose of this chapter is to describe briefly the salient provisions and requirements of the law and the system by which it is administered, so that the reader may obtain a general understanding of the subject before the various provisions are discussed in detail.

[2] Title I of the same act contains definitions applicable to the titles following, and must be consulted in connection with Titles II and III. The act is entitled "An Act to reduce and equalize taxation, to provide revenue, and for other purposes," and may be cited as the "Revenue Act of 1921." (See § 1.)

to corporations for stock, the extension of the net loss provision, and the provision limiting the tax on profits from the sale of capital assets to a maximum of 12½%. Other important changes are: the new scheme for the taxation of insurance companies; the abolition, after December 31, 1921, of the special class of corporations theretofore known as personal service corporations; the limitation of the depletion deduction based on discovery value to the net income of the property upon which discovery is made; the provision in regard to losses established by wash sales; the provision permitting the taxation as a corporation of certain trades or businesses operated by individuals and partnerships in the event of incorporation within four months from the passage of the act; the provision making the filing of consolidated returns by affiliated corporations optional for taxable years beginning after December 31, 1921; the provision limiting the gross income of citizens and domestic corporations, under certain conditions, to gross income from sources within the United States; the provision in regard to income from the sale of property acquired by gift; the allowance of interest on amounts of tax improperly collected and certain new administrative provisions. The provisions of the former law dealing with the taxation of nonresident aliens and foreign corporations have been considerably modified. The taxes imposed by the 1921 Law are in lieu of those imposed by the 1918 Law, and the 1918 Law is repealed except in so far as it remains in force for the assessment and collection of all taxes which have accrued thereunder and for the imposition and collection of penalties with respect thereto. Notwithstanding the changes in the new act just indicated, the Revenue Act of 1921 is in the main a re-enactment of the Revenue Act of 1918, which represented a material advance in income tax legislation. Many of the changes and improvements contained in the present law are founded upon the experience gained by government and taxpayer in the administration of the 1918 Law, and must be read in the light of that experience. For these reasons, and because there are still many points undecided, and many millions of dollars of taxes uncollected or overpaid, under the 1918 Law, it is necessary in this volume to discuss or refer to all decisions, regulations and rulings made thereunder. In large part, these will be as authoritative under the new law as the old. Even where the provisions of the 1918 Law are changed or repealed, however, a discussion of such decisions, regulations and rulings in this work remains necessary; the collection of taxes due and settlement of controversies arising under that law will require several years, under the best

of administrative conditions. This is particularly true with regard to those exceptional provisions of the Revenue Act of 1918 designed to meet the extraordinary situation resulting from the abnormal incomes, losses, and tax rates of the period which embraced the closing of the war and the transition of business from a war to a peace basis—a transition still in progress and underlying many of the provisions of the Revenue Act of 1921.

Preceding Federal Tax Laws. The 1918 Revenue Bill was first introduced in Congress on May 27, 1918, but was not finally enacted until February 24, 1919, after many changes and the substantial modification of many of its provisions. It was designed to raise in 1918 the greatest amount of revenue ever raised in any year in any nation and was drafted with the utmost care in a form which it was hoped would not be changed materially by future enactments except in so far as its provisions were designed to meet war conditions. That this hope was largely justified is shown by a perusal of the Revenue Act of 1921, which, as indicated in the preceding paragraph, follows the scheme of the 1918 Law very closely and is in large part a re-enactment thereof. A discussion of the rates under the 1918 Law and of all its other provisions will be found in the appropriate chapters of this work. In 1917 the Federal Income Tax was imposed by two statutes, prescribing separate and different rates, one additional to the other. The Act of September 8, 1916 (referred to in this book as the 1916 Law), imposed a tax at comparatively low rates and with comparatively high exemptions. It was amended in many respects by the Act of October 3, 1917 (referred to in this book as the 1917 Law), but remained in force as a separate law imposing a general income tax in contradistinction to the "war income tax" at higher rates and with lower exemptions, which was also included in the Act of October 3, 1917. The 1917 War Income Tax Law contained no administrative provisions, but provided that the tax it imposed should be computed, levied, assessed, collected, and paid upon the same basis and in the same manner as similar taxes imposed by the 1916 Law. Generally speaking, both laws were administered as one, and only one annual return of net income was required from each taxpayer, on the basis of which both taxes were assessed. The 1916 Law was preceded by the Act of October 3, 1913 (referred to in this book as the 1913 Law). This law remained in force without change or amendment up to September 8, 1916, when the 1916 Law was enacted and made retroactive to January 1, 1916. The 1913 Law was the first general income tax law after the adoption of the constitutional amendment permitting the im-

position of an income tax without apportionment and without regard to any census or enumeration, but there was in effect in this country, from August 5, 1909, to January 1, 1913, a corporation excise tax act (referred to in this book as the 1909 Law), which imposed a special excise tax on corporations with respect to the carrying on or doing of business by such corporations. Though the 1909 Law was not intended to be and was not in any proper sense an income tax law,[3] the tax was measured by the net income of corporations, and the language of the subsequent income tax laws is in some instances either identical or very similar. To that extent decisions and rulings under the 1909 Law throw light on the construction of the present law and are referred to for that purpose in this book. Rulings and decisions under the 1913, 1916, and 1917 Laws are referred to in this book so far as, in the opinion of the author, they may be of present value to taxpayers in general.[4]

During and after the Civil War income taxes were imposed by the Act of July 1, 1862, the Act of June 30, 1864, and the joint resolution of July 4, 1864, the Act of March 3, 1865, amending the Act of June 30, 1864, the Act of March 2, 1867, and the Act of July 14, 1870. In 1871 the last of the Civil War income tax acts expired and was not re-enacted. No further attempt was made to collect income taxes by the federal government until the Act of August 28, 1894, which was held unconstitutional on the ground that incomes from real property could not be taxed without apportionment.[5] As a result, the Sixteenth Amendment expressly authorized the imposition of a tax on income from all

[3] See language of Justice Pitney in Stratton's Independence v. Howbert, 231 U. S. 399.

[4] Rulings and decisions under all the prior laws should be used with caution in construing the 1918 and 1921 Laws, as these laws contain many new features and change the old law radically in many respects.

[5] Pollock v. Farmers Loan & Trust Co., 157 U. S. 429, 158 U. S. 601. With regard to the history of the income tax, the Wisconsin Court in State v. Frear, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164, said in 1912: "It may be well to note, however, that income taxation is no new and untried experiment in the field of taxation. It has been in use in various forms, and generally with the progressive feature, by many of the civilized governments of the world for decades, which in some instances run into centuries. It has been used at various times by nearly or quite twenty of our own states, and is now in use in several of them. It was used for a brief period by the government of the United States, and is now in successful operation in practically all of the great nations of the civilized world except the United States. The fundamental idea upon which its champions rest their argument in its favor is that taxation should logically be imposed according to *ability to pay*, rather than upon the mere *possession of property*, which for various reasons may produce no revenue to the owner."

sources without apportionment and without regard to any census or enumeration.

Administration of the Laws. The duty of administering the income tax laws and collecting income taxes is imposed on the Bureau of Internal Revenue, which is a part of the Federal Treasury Department. The bureau is under the charge of the Commissioner of Internal Revenue (referred to in this book as the commissioner), who under the direction of the Secretary of the Treasury (referred to in this book as the secretary) has general superintendence of the assessment and collection of all duties and taxes imposed by any law providing for internal revenue.[6] The states and territories are divided into some sixty-four collection districts,[7] each under the charge of a collector of internal revenue, with one or more deputy collectors. Returns of net income are filed with the local collector and the tax is paid to him, although assessments are made by the commissioner at Washington. The commissioner, through his revenue agents or inspectors, has supervisory power over, and authority to investigate, all accounts, lists or returns required to be made by persons liable to tax,[8] may examine the books of such taxpayers, and on refusal to allow an examination, may summon any person or corporation to produce his or its books and to appear before him to give testimony or answer interrogatories under oath respecting the matter.[9] Collectors and the commissioner may make returns for taxpayers from their own knowledge and from such information as they can obtain through testimony or otherwise in cases where the taxpayer fails to file a return or makes a false or fraudulent return.[10] Appeals from decisions of collectors may be taken to the commissioner.[11]

Revenue Agents and Inspectors. The duties of revenue agents and inspectors are to ascertain and report the names of persons who in their opinion are liable to the income tax and

[6] R. S. § 321.

[7] As a rule the boundaries of collection districts coincide with the boundaries of the states, but sometimes one collection district embraces two or three states, or one state is divided into two or more collection districts. Districts within a state are designated by number, as the first and sixth districts of California, being the two districts of that state. The lack of sequence in numbering is due to the consolidation of districts from time to time since the period immediately following the Civil War, when the country was divided into the maximum number of districts.

[8] Revenue Act of 1921, § 1308; Revenue Act of 1918, § 1305. See also U. S. v. Hodson, 14 Int. Rev. Rec. 100; 10 Wall. 395, 406.

[9] R. S. § 3173, as amended by the Revenue Act of 1921.

[10] R. S. § 3176, as amended by the Revenue Act of 1921.

[11] See Chapter 37.

who have failed to make the returns required by law; to inquire into income tax returns where there is any suspicion that the return made is erroneous; to examine the books and accounts of persons who have made returns for the purpose of ascertaining and reporting as to whether or not the law has been complied with, when so ordered by the agent in charge of the division to which they are assigned, who in turn reports to the commissioner, and to the collector of the proper district. In the discharge of their official duties officers of this class are expected to exercise sound discretion, treat all persons with due courtesy, and, while acting firmly and courageously, to avoid all contention or controversy that would give just ground for complaint.[12]

Committee on Appeals and Review. Because of the large number of difficult cases arising under the Internal Revenue Laws, and the amount of revenue involved in the collection of the taxes imposed thereby and to insure fair and adequate consideration of every case arising under such laws, an "Advisory Tax Board" was created by the 1918 Law.[13] The Advisory Tax Board consisted of not more than six [14] members appointed by the commissioner with the approval of the secretary, and was to remain in existence until February 24, 1921, unless abolished before that time by the commissioner with the approval of the secretary. This board was dissolved on October 1, 1919, and its work taken over by a "Committee on Appeals and Review".[15] The commissioner may, and on the request of any taxpayer directly interested must, submit to this committee any question relating to the interpretation or administration of the Internal Revenue Laws. The committee reports its findings and recommendations to the commissioner. Particular attention will be given to problems presenting differences of opinion existing between the taxpayers and the bureau. Such differences occur not only with individuals but also with groups and even with classes of industry. Formal hearings will be given to taxpayers in every case where the facts warrant. The commissioner announced that his policy would be "to employ every means available so that the scales of justice may be held evenly in deciding each case." The committee will be called upon to decide questions involving general aspects of

[12] T. D. 1932.

[13] Revenue Act of 1918, Sec. 1301 (d) (1).

[14] Five memberships on the Advisory Tax Board were announced on March 14, 1919. The sixth membership was reserved as a roving commission for experts to be called from time to time from various industries. (I. T. S. 1919, ¶ 3249.)

[15] Announcement by the commissioner of internal revenue dated September 27, 1919; I. T. S. 1919, ¶ 3587.

taxation and the differentiation of economic activities, accounting, forms of organization, trade customs, industrial management, legal procedure and administration. Special studies will be made of such matters so far as they affect federal taxation.[16]

Tax Simplification Board. The Revenue Act of 1921 establishes a "Tax Simplification Board" to be composed of three members to represent the public, to be appointed by the President and three members to represent the bureau of internal revenue, to be appointed by the secretary. The duty of the board is to investigate the procedure of and forms used by the bureau in the administration of the internal revenue laws and to make recommendations in respect to the simplication thereof.

Rulings and Regulations. The commissioner, with the approval of the secretary, is expressly authorized to make all needful regulations for the enforcement of the provisions of the revenue laws.[17] Such regulations are published under the caption of "Treasury Decisions" and are numbered serially for the purpose of reference.[18] At intervals large compilations of rulings and regulations are published by the Bureau of Internal Revenue and these are designated as "Regulations" and given a serial number.[19] As a general rule, it may be said that these regulations have the force and effect of law and are as binding as if incorporated in the statute.[20] But they must be in execution of or supplementary to, and not in conflict with, the provisions of the statute pursuant to which they are issued.[21] It is also held that they must be reasonable and a regulation defeating the purpose or enlarging the scope of the statute is invalid.[22] In determining

[16] See I. T. S. 1919, ¶ 3251.

[17] Revenue Act of 1921, § 1303; Revenue Act of 1918, § 1309.

[18] Treasury decisions contain rulings on all subjects over which the bureau of internal revenue has jurisdiction. Those relating to the income tax are therefore not numbered in sequence. Reference to treasury decisions is usually made by abbreviation, thus "T. D. 2476."

[19] The last general compilation of rulings on the income tax is known as Regulations No. 45 (1920 edition), promulgated January 28, 1921. All previous rulings and decisions or parts thereof, including Regulations 45 (Preliminary edition) Regulations No. 33, issued January 5, 1914, and Regulations No. 33, Revised, issued February 4, 1918, which are in conflict with those contained in this revised compilation are thereby superseded and revoked, but any former rulings, not inconsistent, remain in effect.

[20] Ex parte Kollock, 165 U. S. 526; U. S. v. Eaton, 144 U. S. 677; Stegall v. Thurman, 175 Fed. 813. See Chapter 47.

[21] Edwards v. Keith, 231 Fed. 110. See Chapter 47.

[22] Campbell v. U. S., 107 U. S. 410; U. S. v. Two Hundred Barrels of Whiskey, 95 U. S. 571; Morrill v. Jones, 106 U. S. 467; U. S. v. Three Barrels, 77 Fed. 963; Greenport Basin & Construction Co. v. U. S., 269 Fed. 58. See Chapter 47.

whether a regulation is consistent with law the courts apply the same rule of decision which controls when an act of congress is assailed as not being within the powers conferred upon congress by the Constitution, and it will not be held invalid unless it is plainly and palpably inconsistent with law and entirely inappropriate to the end specified in the Act of Congress.[23] The promulgation of a regulation does not estop the treasury department from reassessing the tax on a different basis if the courts hold that the regulation was not authorized by the law.[24] Regulations are admissible in evidence when pertinent to the issues, and as the courts take judicial notice of them as public records, it is unnecessary to introduce them formally in evidence.[25] What has been said of regulations applies only to the express terms of the regulation itself regularly promulgated and not to printed headings on a form additional to the express terms.[26] In addition to rulings and regulations the department issues so-called mimeograph letters to collectors, more or less confidential in their character and not intended for general publication. Frequently such letters throw light on the administration of the law and such mimeograph letters as have been made public are referred to in this book. Mimeograph letters are addressed to collectors only and not also "to others concerned" as are the official treasury decisions, and do not affect or give notice to taxpayers. Similarly, instructions to a particular collector do not affect collectors as a class.[27]

Informal Rulings. It was previously the practice of the Bureau of Internal Revenue to make informal rulings in the form of letters, at the request of taxpayers, upon abstract propositions involving questions of tax liability. The bureau will no longer answer such inquiries except under the following circumstances: (1) The transaction must be completed and not merely a proposition or plan, (2) the complete facts relating to the transaction together with abstracts from contracts or other documents necessary to present the complete facts must be submitted, (3) the names of all the real parties interested (not "dummies" used in a transaction) must be stated regardless of who presents the

[23] Boske v. Comingore, 177 U. S. 459. See Chapter 47.

[24] Goldfield Consolidated Mines Co. v. Scott, 247 U. S. 126; N. Y. Life Ins. Co. v. Anderson, 257 Fed. 576.

[25] Sprinkle v. U. S., 141 Fed. 811; Caha v. U. S., 152 U. S. 211; Dominici v. U. S., 72 Fed. 46; Wilkins v. U. S., 96 Fed. 837.

[26] U. S. v. Lamson, 162 Fed. 165.

[27] Landram v. U. S., 16 Ct. Cls. 74.

question, whether attorney, accountant, tax service, or other representative.[28]

BUREAU OF INTERNAL REVENUE INCOME TAX BULLETIN SERVICE. Treasury decisions, certain court decisions and amendments to or modifications of existing regulations affecting the income and excess-profits taxes are published in weekly bulletins issued by the bureau of internal revenue. In addition, these bulletins contain a statement of rulings made in cases arising before the bureau. These informal rulings include committee on appeals and review memoranda, recommendations, mimeograph letters, solicitor's law opinions, opinions of the attorney-general, solicitor's memoranda, solicitor's opinions, and office decisions. Reference is made in this book to these rulings by the abbreviations shown in the table at the front of this volume. The "income tax bulletin service" of the bureau of internal revenue consists, in addition to the weekly bulletins, of bi-monthly digests of rulings published in the weekly bulletins and semi-annual cumulative bulletins containing in full the rulings in the weekly bulletins during the previous six months. The scope and purpose of the above "service" may best be gathered from the statement issued with each weekly bulletin which reads as follows:

"The income tax rulings constitute a service of information from which taxpayers and their counsel may obtain the best available indication of the trend and tendency of official opinion in the administration of the income and profits tax provisions of the revenue acts. The rulings have none of the force or effect of treasury decisions and do not commit the department to any interpretation of law which has not been formally approved and promulgated by the secretary of the treasury. Each ruling embodies the administrative application of the law and treasury decisions to the entire state of facts upon which a particular case arises. It is especially to be noted that the same result will not necessarily be reached in another case unless all the material facts are identical with those of the reported case. As it is not always feasible to publish a complete statement of the facts underlying each ruling, there can be no assurance that any new case is identical with the reported case. As bearing out this distinction, it may be observed that the rulings published from time to time may appear to reverse rulings previously published.

[28] Statement by the bureau of internal revenue dated August 26, 1919, I. T. S. 1919, ¶ 3538.

"Officers of the bureau of internal revenue are especially cautioned against reaching a conclusion in any case merely on the basis of similarity to a published income tax ruling, and should base their judgment on the application of all pertinent provisions of the law and treasury decisions to all of the facts in each case. The income tax rulings should be used merely as aids in studying the law and the treasury decisions."

RETROACTIVE EFFECT OF RULINGS. Treasury department decisions promulgating rulings of the internal revenue bureau become effective upon the date of approval unless otherwise stated therein. Cases previously adjusted in contravention of law as pronounced in such decisions, are subject to readjustment in accordance with the decisions.[29] Generally speaking, any ruling or regulation made by the treasury department supersedes all prior rulings and regulations and is retroactive to the time the law was enacted, since a ruling or regulation is merely an interpretation of the meaning of the law, and in theory the meaning has been the same from the beginning. The treasury department recognizes, however, that in some instances it would be unjust or impracticable to reopen returns, adjustments or assessments which have been made in accordance with previous rulings, and where such rulings are superseded, an express limitation is made in the superseding ruling or regulation as to the retroactive effect thereof.[30] The Revenue Act of 1921 expressly permits amending regulations to be applied without retroactive effect.[31]

United States. The term "United States" where used in a geographical sense in the law includes only the states, the territories of Alaska and Hawaii, and the District of Columbia.[32]

Possessions of the United States. The Revenue Act of 1921 does not extend to possessions of the United States. An individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, is taxable only on income derived from sources within the United States. In such cases the tax is computed and paid in the same manner as in the case of other persons who are taxable only as to income from such sources.[33]

29 Reg. 33 Rev., Art. 38.

30 See last paragraph of mimeograph letter to collectors dated August 14, 1914; I. T. S. 1918, ¶¶ 392 and 1344; also the last paragraph of T. D. 2313 and T. D. 2317.

31 Revenue Act of 1921, § 1314.

32 Revenue Act of 1921, § 2 (5); Revenue Act of 1918, § 1.

33 Revenue Act of 1921, § 260; Revenue Act of 1918, § 260.

Porto Rico and the Philippines. The Revenue Act of 1921 provides that in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected and paid as provided by law prior to its passage, and that the Porto Rican or Philippine legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands respectively.[34] The Revenue Act of 1918, which went into effect on February 24, 1919, provided a local income tax law for these possessions by making the Revenue Act of 1916, as amended, apply to them, and gave the legislatures of these possessions the same power as is given by the present law to amend, alter, modify or repeal the income tax laws in force in such possessions.[35] On July 26, 1919, the Porto Rican legislature repealed the 1916 law, as amended, with respect to Porto Rico,[36] and on March 7, 1919, the 1916 Law, as amended, was similarly superseded with respect to the Philippine Islands.[37] Under the present law a citizen or resident of the United States, and a domestic corporation, is entitled, with certain limitations, to deduct the amount of income, war-profits and excess-profits taxes paid to those possessions from the amount of such taxes due to the United States.[38]

Gross Income. Gross income is defined in the law to include income, gains or profits of all kinds except those enumerated as exempt from taxation. A more complete definition will be found in a subsequent chapter.[39]

Net Income. Net income is defined as gross income less the deductions allowed by the law, as is more fully stated in a subsequent chapter.[40] The Revenue Act of 1918[41] for the first time required net income to be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case might be) in accordance with the method of accounting employed in keeping the books of such taxpayer. This provision was retained in the present law.[42] If no method of accounting has been employed or if the method employed does not clearly reflect the income, the computation is to be made upon

[34] Revenue Act of 1921, § 261.

[35] Revenue Act of 1918, § 261.

[36] See Laws of Porto Rico, § 77, The Income Tax Law.

[37] See Laws of the Philippines, § 2, An Act Establishing the Income Tax.

[38] Revenue Act of 1921, §§ 222, 238, Reg. 45, Arts. 1132 and 1133. No limitation existed under the 1918 law. See Revenue Act of 1918, §§ 222, 238.

[39] See Chapter 14.

[40] See Chapter 14.

[41] Revenue Act of 1918, § 212 (b).

[42] Revenue Act of 1921, § 212 (b).

such basis and in such manner as in the opinion of the commissioner does clearly reflect the income.[43]

Deductions and Credits. The law specifies that certain deductions may be made from gross income in ascertaining the net income of the taxpayer. "Deductions" reduce income for all purposes. "Credits" do not reduce net income for all purposes, but reduce the net income of an individual for the purpose of the normal tax and not the surtax, or, in the case of a corporation, reduce net income for the purpose of the income tax and not the excess-profits tax. Another form of credit provided by the law may be applied directly against the tax and not against the net income. These distinctions are more fully stated and explained in subsequent chapters.[44]

Reporting Net Income. Taxpayers are required to file annually a return showing the amount of gross income received, the deductions, credits and exemptions claimed and the net income upon which the tax is to be imposed. This return is filed in the collection district in which the taxpayer resides or has his principal place of business. Nonresidents having no place of business in this country file their returns with the collector of internal revenue at Baltimore, Maryland.[45] Except in the case of nonresident aliens and foreign corporations, the returns are required to be filed on or before March 15, if the report is made for the preceding calendar year, or if made for a fiscal year, the returns are required to be filed on or before the 15th day of the third month following the close of the fiscal year. In the case of nonresident aliens and foreign corporations, returns are required to be filed on or before the 15th day of the sixth month following the close of the fiscal year, or, if the return is made on a calendar year basis, then on or before June 15. The commissioner may grant a reasonable extension of time for filing return whenever, in his judgment, good cause exists.[46] Under both the present law and the 1918 law individuals and corporations are required to file their returns for their fiscal years instead of for the calendar year if they keep books of account which are regularly closed each year at the end of some month other than December. An important change initiated by the 1918 law and retained by the present law is that partnerships are required to

[43] Revenue Act of 1921, § 212; Revenue Act of 1918, § 212.

[44] See Chapters 31 and 32.

[45] Revenue Act of 1921, §§ 229 and 241. Revenue Act of 1918, §§ 227 and 241. This district is the one in which Washington, the national capital, is located.

[46] Revenue Act of 1921, §§ 227 and 241. Revenue Act of 1918, §§ 227 and 241.

file annual returns showing their net income although they are not subject to tax as partnerships.[47]

Record to Be Kept. Every individual, partnership or corporation liable to any tax imposed by the internal revenue laws of the United States, or for the collection thereof, is required to keep such records, to render such statements and returns under oath, and to comply with such regulations as shall be prescribed by the commissioner. The commissioner may also examine any books, papers, records or memoranda of a taxpayer.[48]

Individuals. Ordinarily, no person whose net income is less than $1,000 in any calendar year is required to file a return for that year, but the commissioner may require any person, whether liable to tax or not, to file returns of income or such statements as he may deem sufficient to show whether or not such person is liable to tax.[49] Under both the 1918 Law and the present law unmarried persons and married persons not living with husband or wife and receiving $1,000 or more net income during the calendar year, and married persons living with husband or wife and receiving $2,000 or more net income during the same period, are required to file annual returns.[50] Under the 1921 Law, in addition to the above, every individual having a gross income for the taxable year of $5,000, or over, regardless of the amount of his net income, must file a return, and if a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000, or over, separate returns or a joint return must be made.[51] Minors are required to file returns if they have received the minimum amount of income specified in the law. Prior to 1918 returns were required only of persons of lawful age.[52]

PERSONAL EXEMPTION. The personal exemption, or credit, is an arbitrary amount of net income on which residents and citizens (in some cases nonresident aliens) are not liable to the normal tax.[53] It may be said to be an amount allowed for personal or family expenses, the actual amount of such expenses not being deductible in ascertaining net income. The amount of the

[47] Revenue Act of 1918, § 224, see Chapter 8.

[48] Revenue Act of 1921, §§ 1300, 1308 and 1309; Revenue Act of 1918, § 1305; Reg. 45, Art. 1711; Reg. 33 Rev., Art. 50.

[49] Revenue Act of 1921, § 1307.

[50] Revenue Act of 1921, § 223; Revenue Act of 1918, § 223.

[51] Revenue Act of 1921, § 223.

[52] See Chapter 34 for a further discussion of this subject.

[53] Revenue Act of 1921, §§ 216 and 217; Revenue Act of 1918, §§ 216 and 217.

personal exemption allowed to an individual depends upon his status. Married persons living together and heads of families, whether married or not, are entitled to an exemption of $2,000, unless the net income is less than $5,000, in which case the exemption is $2,500. Others are entitled to $1,000. An additional exemption of $400 is allowed to any taxpayer, whether single or married or head of a family, for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.[54] Under the 1918 Law, a nonresident alien was entitled to claim these exemptions to the same extent as a citizen or resident, unless he was a citizen or subject of a country which imposed an income tax and did not allow a similar exemption or credit to citizens of the United States not residing in such country. Under the present law, nonresident alien individuals and certain citizens whose income is largely from sources within a possession of the United States[55] are entitled only to a personal exemption of $1,000 and are not entitled to any exemption on account of dependents.[56] The personal exemption may be deducted only in computing the normal tax.[57] The 1918 Law provided that domestic corporations should be entitled to an exemption of $2,000.[58] Under the present law a specific credit of $2,000 is allowed to domestic corporations whose net income is $25,000 or less, but if the net income is more than $25,000, the income tax is limited to an amount not in excess of that which would be payable if the credit of $2,000 were allowed, plus the amount of net income in excess of $25,000.[59]

Normal Tax. The normal tax is a tax imposed upon all the net income of an individual in excess of (a) dividends received from domestic and certain foreign corporations; (b) interest upon bonds and other obligations of the United States issued after September 1, 1917; (c) interest upon bonds issued by the War Finance Corporation; (d) the personal exemption and (e)

[54] Revenue Act of 1921, § 216. This exemption was $200 under the 1918 Law (Revenue Act of 1918, § 216). Prior to the 1918 Law this exemption of $200 was limited to cases of *children* dependent upon the taxpayer.

[55] See Revenue Act of 1921, § 262.

[56] See Revenue Act of 1921, § 216 (e).

[57] For a further discussion of the personal exemption, see Chapter 31.

[58] Prior to the 1918 Law, corporations were not allowed an exemption similar to the personal exemption allowed to individuals.

[59] Revenue Act of 1921, § 236 (b).

the exemption for dependent persons.[60] For the year 1919 and subsequent years the rate of normal tax in the case of citizens and residents of the United States is 4% on the first $4,000 of income subject to normal tax and 8% on the remainder; and in the case of nonresident aliens 8% on all net income from sources within the United States subject to normal tax.[61]

Surtax. A surtax (sometimes called "supertax" or "additional tax") is imposed upon the entire net income of individuals in excess of $5,000 without deducting the personal exemption and including dividends and interest on United States obligations, issued after September 1, 1917, and bonds of the War Finance Corporation. The surtaxes are imposed by a series of graduated rates. The first rate, for the taxable years 1918 to 1921, inclusive, is imposed on that part of the net income which exceeds $5,000 and does not exceed $6,000. Each additional $2,000 of net income is subject to a higher rate of tax than the preceding one up to and including $100,000, and thereafter the surtax is increased at less frequent intervals on income up to $1,000,000, the final rate being 65% on the amount by which the net income exceeds $1,000,000.[62] For 1922 and succeeding years the first

[60] Revenue Act of 1921, § 216; Revenue Act of 1918, § 216. The distinction made between incomes subject to normal tax and incomes subject to surtax is artificial and necessary only for the purpose of granting certain partial exemptions or taxing various kinds of income at different rates. The distinction between normal taxes and surtax seems to have originated in England, where the income tax was first imposed at a proportional rate on all income and later graduated rates were applied to incomes over a minimum limit. One reason for distinguishing between normal taxes and surtaxes under our 1913 Law lay in the fact that the statute provided for withholding at the source of the normal tax, as does the English Law. Under the 1913 Law and the 1916 Law the normal tax was the rate which applied to corporations and individuals alike, but under the 1918 Law and the present law this characteristic is destroyed since the normal tax is also a graduated tax. The law will no doubt always retain the distinction between normal and surtaxes, since bonds of the United States are issued exempt from "normal tax," an exemption which, by the way, is uncertain and precarious since it is within the power of congress to reduce the normal tax at any time to a minimum and thereby practically destroy the tax exemption or raise the normal tax as is done by the present law in order to increase the exemption.

[61] Revenue Act of 1918, § 210; Revenue Act of 1921, § 210. For the year 1918 the rate of normal tax in the case of citizens and residents of the United States was 6% on the first $4,000 of income subject to normal tax and 12% on the remainder. Nonresident aliens were subject to a normal tax at the rate of 12% on all of the net income subject to normal tax received from all sources in the United States.

[62] Revenue Act of 1918, § 211; Revenue Act of 1921, § 211 (a) (1). See Chapter 2 for a schedule of rates of this tax.

rate of surtax is 1%, and applies to the amount of net income between $6,000 and $10,000. In general, each additional $2,000 of net income is subject to a higher rate up to and including $100,000. The maximum surtax rate for such years is 50%, which applies to all net income in excess of $200,000.[63]

Corporation Tax. The income tax imposed on corporations is at the rate of 10%, for the calendar year 1921, and 12½% for succeeding years.[64] This rate might formerly be said to measure the normal tax imposed on corporations in contradistinction to the graduated excess-profits tax which was also imposed on corporations. But this is hardly true after 1921, when the excess-profits tax is abolished, and the income tax on corporations raised in lieu thereof. For the purpose of the income tax the net income which is subject to the excess-profits tax is reduced by deducting therefrom certain credits consisting of (a) interest on the bonds and obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance Corporation; (b) the amount of any excess-profits tax imposed on the net income for the same taxable year; and (c) in the case of a domestic corporation the sum of $2,000 subject to the conditions stated in a previous paragraph.[65] Certain classes of corporations not organized for profit, both domestic and foreign, are exempt from this tax.[66]

Personal Service Corporations. The 1918 Law recognized a new class of corporations—those whose income is due primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital is not a material income-producing factor. Such corporations are recognized as being taxable in the same manner as partnerships; that is, the corporation is required to pay no tax but the stockholders are required to include in their personal returns their distributive shares of all the profits of such corporations whether distributed or not. Personal service corporations are composed, for instance, of professional men or agents who have adopted the corporate form merely as an incidental convenience. The law expressly provides that no foreign corporation shall be considered to be a personal service corporation, nor shall any corporation be so considered if 50% of its gross income consists either of gains, profits or

63 Revenue Act of 1921, § 211 (a) (2).

64 This rate was 12% for the year 1918 and 10% for 1919 and 1920. See Revenue Act of 1918, § 230, and Revenue Act of 1921, § 230.

65 Revenue Act of 1921, §§ 230 and 236; Revenue Act of 1918, §§ 230 and 236. This subject is more fully discussed in Chapter 10.

66 See Chapter 13 for list of exempt corporations.

income derived from trading as a principal or of gains, profits, commissions or other income, derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[67] Under the present law, such corporations are taxed as above for 1921 only, after which they will be subject to tax as other corporations.[68]

Partnerships. A partnership itself is not taxable, but the members of the partnership are required to report their distributive shares of the partnership income, whether such income is actually distributed or not. All partnerships are required to file annual returns of income for the purpose of showing the amount of net income distributable to each partner.[69]

Collection of the Tax at the Source. Collection at the source, deduction at the source, withholding at the source and stoppage at the source, are synonymous terms meaning that the one paying income to another deducts or withholds an amount equal to the tax on the sum so paid and turns it over to the government to the credit of the one against whom it is withheld. This method is used in order to facilitate the collection and to prevent evasion of the tax. Under the 1913 Law, and the 1916 Law during the year 1916, the normal tax was withheld on payments to individuals, whether citizens, residents or nonresident aliens. Under the 1916 Law, as amended by the 1917 Law, the tax was not withheld on payments of income to citizens and residents (except in the case of bonds containing tax-free covenants).[70] Collection at the source applies at the present time only to (1) payments of fixed and determinable annual or periodical income to nonresident aliens, or partnerships composed in whole or in part of nonresident aliens, in which case the tax is to be withheld at the rate of 8% (and if the commissioner so rules the nonresident alien may claim exemption from withholding to the extent of his personal exemption); (2) payments of the same kind of income to nonresident foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, in which case the tax is to be withheld at the rate of 10% for 1921, and 12½% for subsequent years; and (3) the commissioner may authorize deduction[71] at

[67] Revenue Act of 1918, § 200; Revenue Act of 1921, § 200. For further discussion of this subject see Chapter 9.

[68] Revenue Act of 1921, § 218 (d).

[69] Revenue Act of 1921, § 224; Revenue Act of 1918, § 224.

[70] Revenue Act of 1916, § 9 (c) as amended by Revenue Act of 1917.

[71] The law is not clear whether the commissioner may authorize deduction at the rate of 8% or 10% or 12½% in the case of bonds not having "tax-free covenants" and it seems to be within his discretion.

the source in the case of payments of any interest upon any securities the owners of which are not known to the withholding agent; (4) in the case of payments of interest on bonds and similar obligations of domestic corporations which contain a so-called "tax-free covenant," the tax to be withheld in all such cases to be limited to 2%, whether the owner be a citizen or resident or a nonresident alien or a foreign corporation or a domestic or foreign partnership. The only bondholders to which the last mentioned provision does not apply are domestic and resident corporations. The commissioner may authorize the tax of 2% to be withheld on interest on "tax-free covenant" bonds where the owner is not known.[72] It is to be noted that the only case in which withholding against citizens or residents of this country takes place is (4) above. In such cases the law is made to operate in order that the debtor corporation issuing such "tax-free covenant" bonds may be compelled to assume a part of the tax of the bondholder, since withholding does not actually take place.[73]

Information at the Source. For the purpose of checking up the returns of taxpayers the law provides for a system of information at the source, whereby every corporation may be required to report to the commissioner the names and addresses of its stockholders and the amount of dividends paid to each;[74] brokers may also be required, when called upon, to report the names and addresses of customers and furnish information as to the profits and losses of each;[75] and all persons, corporations or partnerships may be required to report the names and addresses of any persons to whom they pay fixed or determinable gains, profits or income of $1,000 or more in any taxable year. In the case of payments of interest to the bondholders of corporations the names and addresses of such bondholders are required to be reported, regardless of the amount paid during the year, and this is also true in the case of the collection of foreign items of interest and dividends.[76]

Payment of the Tax. The income tax is due and payable in four installments, each consisting of one-fourth of the total tax. The first installment is payable at the time when the return is due to be filed, unless an extension of time for filing the return is granted, in which case the first installment is due at the

72 Revenue Act of 1921, §§ 221 and 237; Revenue Act of 1918, §§ 221 and 237.

73 For a further discussion of this subject see Chapter 40.

74 Revenue Act of 1921, § 254; Revenue Act of 1918, § 254.

75 Revenue Act of 1921, § 255; Revenue Act of 1918, § 255.

76 Revenue Act of 1921, § 256; Revenue Act of 1918, § 256.

expiration of such extended period with interest at the rate of one-half of 1 per cent. per month from the date on which the return was originally due to be filed. Such an extension does not postpone the time of payment of subsequent installments. In the event of default in the payment of any installment the whole amount of tax still unpaid becomes due and payable upon notice and demand by the collector. The above provisions do not apply to taxes collected at the source. The tax may be paid in a single payment instead of in installments.[77] No discount is allowed where such an advance payment is made. Receipts are not given for taxes paid, except upon the request of the taxpayer.[78]

Abatement and Refund. The collection of the income tax cannot be restrained by injunction, but the commissioner is authorized to remit and pay back to the taxpayer any taxes which have been erroneously or illegally collected. The importance of collecting revenue is so great that the law permits no taxpayer to interpose a hindrance to the orderly assessment of the tax. He must allow the tax to be assessed and claim abatement or refund thereafter.[79]

77 Revenue Act of 1921, § 250 (a); Revenue Act of 1918, § 250 (a).
78 Revenue Act of 1921, § 251; Revenue Act of 1918, § 251.
79 See Chapter 38.

CHAPTER 2

THE INCOME TAX RATES

As indicated in the foregoing chapter, the income tax is imposed generally at two rates (called the normal tax) on a part of the net income, and at a series of progressive rates (called the surtax)[1] on the net income over $6,000. In the case of corporations no surtax is imposed, the income tax rate being uniform on all amounts of net income. For the year 1921 and subsequent years, the income tax is imposed by the Revenue Act of 1921. It was imposed by the Revenue Act of 1918 for the years 1918, 1919 and 1920.

Normal Tax. Under both the Revenue Act of 1918 and the Revenue Act of 1921 a normal tax of 4%[2] is imposed upon the first $4,000 of taxable net income of citizens and residents for the calendar year 1919 and subsequent years, and a normal tax of 8%[3] upon the remainder of such taxable net income.[4] In the case of nonresident alien individuals the rate is 8%[5] on the taxable net income.[6] The following items are deducted from net income, under the Revenue Act of 1921, to determine taxable net income in assessing the normal tax of citizens or residents: (a) dividends from a domestic corporation (except a domestic corporation deriving the greater part of its income from sources within a possession of the United States) and a foreign corporation deriving more than 50% of its income from sources within the United States; (b) interest upon obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance Corporation which is included in gross income; (c) the personal exemption and credit for dependents.[7] No credit

[1] In 1917 the income tax was assessed and collected under two laws (the Revenue Act of 1916 and the Revenue Act of 1917); but it is now, as in 1918-1921, assessed and collected under one law—the Revenue Act of 1918 for the years 1918-1920 and the Revenue Act of 1921 for 1921 and subsequent years.

[2] This rate was 6% for the calendar year 1918 under the 1918 Law.

[3] This rate was 12% for the calendar year 1918 under the 1918 Law.

[4] Revenue Act of 1921, § 210; Revenue Act of 1918, § 210 (b); Reg. 45, Art. 2. The subject of income is treated fully in Chapter 14 et seq.

[5] This rate was 12% for the calendar year 1918 under the 1918 Law.

[6] In the case of nonresident alien individuals only income from sources within the United States is taxable; Revenue Act of 1921, § 213 (c); Revenue Act of 1918, § 213 (c).

[7] Revenue Act of 1921, §§ 210, 216 and 262. This is different from the corresponding provision of the Revenue Act of 1918 (§ 216) in regard to the

for dependents is allowed in assessing the normal tax of nonresident alien individuals, the remaining above items are deducted only on the condition that the nonresident alien files a return of his total income received from all sources, corporate or otherwise, in the United States, including therein all information which the commissioner may deem necessary for the calculation of his credits and deductions.[8] On all the net income in excess of the above items the normal tax rates apply.[9]

COMPARATIVE STATEMENT OF NORMAL TAX RATES. The rates of normal tax under the various laws since March 1, 1913, are as follows:

1913—1%; 1916—2%; 1917—2%; 1918—6% and 12% for the year 1918 and 4% and 8% for 1919 and 1920; 1921—4% and 8%. The corporation tax for each of the years up to 1917 was the same as the normal tax. In 1917 the normal tax rates imposed by the 1916 and 1917 Laws were applied to incomes of citizens and residents, but only the 1916 rate to nonresident aliens, while the corporation tax was 6%. For the year 1918, the corporation tax was the same as the higher of the normal tax rates for individuals (12%); for 1919 and 1920, it was 10%. It remains at 10% under the present law for 1921, but goes up to 12½% for 1922 and subsequent years.[10]

Surtax. In addition to the normal tax a surtax is imposed at various and graduated rates under the present law. For the purpose of assessing the surtax the items deductible from net income for normal tax purposes and the personal exemption are not deducted.[11]

LIMITATION IN CASE OF SALES OF MINES, OIL, OR GAS WELLS. In the case of a *bona fide* sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has

dividends which may be credited. Under that law dividends from a corporation taxable on its net income could be credited, and also from a personal service corporation out of earnings subject to income tax. With regard to dividends from a personal service corporation under the present law, see Chapter 31.

[8] Revenue Act of 1921, § 217 (g); Revenue Act of 1918, § 217. Under the 1918 Law (§ 216 (e)), in the case of nonresident alien individuals who are citizens or subjects of a foreign country imposing an income tax, the personal exemption was allowed only if such country allowed a similar credit to citizens of the United States not residing in such country.

[9] Revenue Act of 1921, § 210; Revenue Act of 1918, § 210.

[10] Cf. Revenue Act of 1921, §§ 230, 210, and Revenue Act of 1918, §§ 230, 210.

[11] Revenue Act of 1921, § 211; Revenue Act of 1918, § 211 (a); Reg. 45, Art. 11. The surtax was called "the additional tax" in the 1916 law and the 1917 law.

been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the surtax attributable to such sale cannot exceed for the calendar year 1921, 20%, and for each calendar year thereafter 16% of the selling price.[12] Exploration work alone without discovery is not sufficient to bring a case within this provision. Shares of stock in a corporation owning mines, oil or gas wells do not constitute an interest in such property. To determine the application of this provision to a particular case, the taxpayer should first compute the surtax in the ordinary way upon his net income, including his net income from any such sale. The proportion of the surtax indicated by the ratio which the taxpayer's net income from the sale of the property, bears to his total net income is the portion of the surtax attributable to such sale, and if it exceeds the above percentage of the selling price of the property, such portion of the surtax should be reduced to that amount.[13] Where individuals transfer property to a corporation which later demonstrates the principal value of such property as oil-producing property "by prospecting or exploration and discovery work" and then dissolves, transferring the property to the individuals, who had remained stockholders without change in interests, and such stockholders sell the property, the portion of the surtax attributable to such sale is not limited to 20% or 16% of the selling price of such property or interests.[14] The limitation with respect to the tax attributable to the sale of mines, oil or gas wells, or any interest therein has no application to the tax on profits realized from the sale of oil and gas produced in the operation of such wells.[15]

LIMITATION IN THE CASE OF CAPITAL GAINS. If the taxpayer so elects, neither the normal nor the surtaxes imposed for the year 1922 and subsequent years apply to net gains from the sale or exchange of capital assets consummated after December

[12] Revenue Act of 1921, § 211 (b); Revenue Act of 1918, § 211 (b).

[13] Reg. 45, Art. 13. It should be noted that this construction of the statute is reached from the government's viewpoint. The courts would perhaps under some circumstances hold that shares of stock in a corporation owning the property constitute an interest in the property within the meaning of the statute. See discussion of the doctrine of corporate entity in Chapter 10. It seems also that the method here presented for calculating the surtax applicable to such sale is open to question. The portion of the tax attributable to such sale is clearly the difference between the amount of surtax computed on the entire net income and the amount computed on the net income less the profit on the sale—and not the proportion indicated in the text.

[14] T. B. R. 8, T. B. 3-19-176.

[15] O. D. 658, T. B. 37-20-1190.

31, 1921, such net gains being the amount over and above (a) losses resulting from the sale of capital assets consummated after that date and (b) deductions properly allocable to or chargeable against capital gains. At the election of the taxpayer, an ungraduated tax of 12½% is imposed on such capital net gains, the balance of the taxpayer's income being liable to the normal and surtaxes.[16]

COMPARATIVE STATEMENT OF SURTAX RATES. The rates of surtax under the various laws since March 1, 1913, are as follows:

On the amount by which the total net income

Exceeds	But does not exceed	1921 Law*	1918 Law**	1917 Law	1916 Law	1913 Law
$ 5,000	$ 6,000	None	1%	1%	None	None
6,000	7,500	1%	2%	1%	None	None
7,500	8,000	1%	2%	2%	None	None
8,000	10,000	1%	3%	2%	None	None
10,000	12,000	2%	4%	3%	None	None
12,000	12,500	3%	5%	3%	None	None
12,500	14,000	3%	5%	4%	None	None
14,000	15,000	4%	6%	4%	None	None
15,000	16,000	4%	6%	5%	None	None
16,000	18,000	5%	7%	5%	None	None
18,000	20,000	6%	8%	5%	None	None
20,000	22,000	8%	9%	7%	1%	1%
22,000	24,000	9%	10%	7%	1%	1%
24,000	26,000	10%	11%	7%	1%	1%
26,000	28,000	11%	12%	7%	1%	1%
28,000	30,000	12%	13%	7%	1%	1%
30,000	32,000	13%	14%	7%	1%	1%
32,000	34,000	15%	15%	7%	1%	1%
34,000	36,000	15%	16%	7%	1%	1%
36,000	38,000	16%	17%	7%	1%	1%
38,000	40,000	17%	18%	7%	1%	1%
40,000	42,000	18%	19%	10%	2%	1%
42,000	44,000	19%	20%	10%	2%	1%
44,000	46,000	20%	21%	10%	2%	1%
46,000	48,000	21%	22%	10%	2%	1%
48,000	50,000	22%	23%	10%	2%	1%

[16] Revenue Act of 1921, § 206. This subject is more fully discussed in Chapter 17.

* For 1922 and subsequent years.

**Also the 1921 Law for 1921.

Exceeds	But does not exceed	1921 Law*	1918 Law**	1917 Law	1916 Law	1913 Law
$ 50,000	$ 52,000	23%	24%	10%	2%	2%
52,000	54,000	24%	25%	10%	2%	2%
54,000	56,000	25%	26%	10%	2%	2%
56,000	58,000	26%	27%	10%	2%	2%
58,000	60,000	27%	28%	10%	2%	2%
60,000	62,000	28%	29%	14%	3%	2%
62,000	64,000	29%	30%	14%	3%	2%
64,000	66,000	30%	31%	14%	3%	2%
66,000	68,000	31%	32%	14%	3%	2%
68,000	70,000	32%	33%	14%	3%	2%
70,000	72,000	33%	34%	14%	3%	2%
72,000	74,000	34%	35%	14%	3%	2%
74,000	75,000	35%	36%	14%	3%	2%
75,000	76,000	35%	36%	14%	3%	3%
76,000	78,000	36%	37%	14%	3%	3%
78,000	80,000	37%	38%	14%	3%	3%
80,000	82,000	38%	39%	18%	4%	3%
82,000	84,000	39%	40%	18%	4%	3%
84,000	86,000	40%	41%	18%	4%	3%
86,000	88,000	41%	42%	18%	4%	3%
88,000	90,000	42%	43%	18%	4%	3%
90,000	92,000	43%	44%	18%	4%	3%
92,000	94,000	44%	45%	18%	4%	3%
94,000	96,000	45%	46%	18%	4%	3%
96,000	98,000	46%	47%	18%	4%	3%
98,000	100,000	47%	48%	18%	4%	3%
100,000	150,000	48%	52%	22%	5%	4%
150,000	200,000	49%	56%	25%	6%	4%
200,000	250,000	50%	60%	30%	7%	4%
250,000	300,000	50%	60%	34%	8%	5%
300,000	500,000	50%	63%	37%	9%	5%
500,000	750,000	50%	64%	40%	10%	6%
750,000	1,000,000	50%	64%	45%	10%	6%
1,000,000	1,500,000	50%	65%	50%	11%	6%
1,500,000	2,000,000	50%	65%	50%	12%	6%
2,000,000	....	50%	65%	50%	13%	6%

* For 1922 and subsequent years.

**Also the 1921 Law for 1921.

The 1913 rates applied in 1913, 1914, and 1915; the 1916 rates in 1916; the 1916 and 1917 rates were both imposed in 1917; the

1918 rates apply to 1918, 1919, 1920 and 1921,[17] and the 1921 rates to 1922 and subsequent years.

SURTAX TABLES FOR 1921 AND PRIOR YEARS. The following table shows the surtax for 1918, 1919, 1920, and 1921 on net incomes of the specified amounts. In each instance the first figure of net income in the net income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the net income column, and the sum in the next column is the tax on the entire difference between the first figure and the second figure in the net income column. The final column gives the total surtax on a net income equal to the second figure in the net income column.

Net income	Per cent	Surtax	Total surtax
$ 5,000 to $ 6,000	1	$ 10	$ 10
6,000 to 8,000	2	40	50
8,000 to 10,000	3	60	110
10,000 to 12,000	4	80	190
12,000 to 14,000	5	100	290
14,000 to 16,000	6	120	410
16,000 to 18,000	7	140	550
18,000 to 20,000	8	160	710
20,000 to 22,000	9	180	890
22,000 to 24,000	10	200	1,090
24,000 to 26,000	11	220	1,310
26,000 to 28,000	12	240	1,550
28,000 to 30,000	13	260	1,810
30,000 to 32,000	14	280	2,090
32,000 to 34,000	15	300	2,390
34,000 to 36,000	16	320	2,710
36,000 to 38,000	17	340	3,050
38,000 to 40,000	18	360	3,410
40,000 to 42,000	19	380	3,790
42,000 to 44,000	20	400	4,190
44,000 to 46,000	21	420	4,610
46,000 to 48,000	22	440	5,050
48,000 to 50,000	23	460	5,510
50,000 to 52,000	24	480	5,990
52,000 to 54,000	25	500	6,490
54,000 to 56,000	26	520	7,010
56,000 to 58,000	27	540	7,550
58,000 to 60,000	28	560	8,110

[17] The 1918 rates apply to 1921, but they are imposed by the 1921 Law.

Net income	Per cent	Surtax	Total surtax
$ 60,000 to $ 62,000........	29	$ 580	$ 8,690
62,000 to 64,000........	30	600	9,290
64,000 to 66,000........	31	620	9,910
66,000 to 68,000........	32	640	10,550
68,000 to 70,000........	33	660	11,210
70,000 to 72,000........	34	680	11,890
72,000 to 74,000........	35	700	12,590
74,000 to 76,000........	36	720	13,310
76,000 to 78,000........	37	740	14,050
78,000 to 80,000........	38	760	14,810
80,000 to 82,000........	39	780	15,590
82,000 to 84,000........	40	800	16,390
84,000 to 86,000........	41	820	17,210
86,000 to 88,000........	42	840	18,050
88,000 to 90,000........	43	860	18,910
90,000 to 92,000........	44	880	19,790
92,000 to 94,000........	45	900	20,690
94,000 to 96,000........	46	920	21,610
96,000 to 98,000........	47	940	22,550
98,000 to 100,000........	48	960	23,510
100,000 to 150,000........	52	26,000	49,510
150,000 to 200,000........	56	28,000	77,510
200,000 to 300,000........	60	60,000	137,510
300,000 to 500,000........	63	126,000	263,510
500,000 to 1,000,000........	64	320,000	583,510
1,000,000 up	65	......	......

The surtax for any amount of net income not shown in the above table is computed by adding to the total surtax for the largest amount shown which is less than the income, the surtax upon the excess over that amount at the rate indicated in the table. For example, if the amount of net income is $63,128, the surtax is the sum of $8,690 (the surtax upon $62,000 as shown by the table) plus 30 per cent. of $1,128, or $338.40, making a total surtax of $9,028.40.[18]

Surtax Tables For 1922 and Subsequent Years. The following table shows the surtax for 1922 and subsequent years on net incomes of the specified amounts. This table is prepared in a manner similar to the above table for 1921 and prior years, and the surtax for any amount not shown is computed by adding to the total surtax for the largest amount shown which is less than the income, the surtax upon the excess at the rate indicated in the table.

[18] Reg. 45, Art. 12.

Net income	Per cent	Surtax	Total surtax
$ 6,000 to $ 10,000	1	$ 40	$ 40
10,000 to 12,000	2	40	80
12,000 to 14,000	3	60	140
14,000 to 16,000	4	80	220
16,000 to 18,000	5	100	320
18,000 to 20,000	6	120	440
20,000 to 22,000	8	160	600
22,000 to 24,000	9	180	780
24,000 to 26,000	10	200	980
26,000 to 28,000	11	220	1,200
28,000 to 30,000	12	240	1,440
30,000 to 32,000	13	260	1,700
32,000 to 36,000	15	300	2,000
36,000 to 38,000	16	320	2,320
38,000 to 40,000	17	340	2,660
40,000 to 42,000	18	360	3,020
42,000 to 44,000	19	380	3,400
44,000 to 46,000	20	400	3,800
46,000 to 48,000	21	420	4,220
48,000 to 50,000	22	440	4,660
50,000 to 52,000	23	460	5,120
52,000 to 54,000	24	480	5,600
54,000 to 56,000	25	500	6,100
56,000 to 58,000	26	520	6,620
58,000 to 60,000	27	540	7,160
60,000 to 62,000	28	560	7,720
62,000 to 64,000	29	580	8,300
64,000 to 66,000	30	600	8,900
66,000 to 68,000	31	620	9,520
68,000 to 70,000	32	640	10,160
70,000 to 72,000	33	660	10,820
72,000 to 74,000	34	680	11,500
74,000 to 76,000	35	700	12,200
76,000 to 78,000	36	720	12,920
78,000 to 80,000	37	740	13,660
80,000 to 82,000	38	760	14,420
82,000 to 84,000	39	780	15,200
84,000 to 86,000	40	800	16,000
86,000 to 88,000	41	820	16,820
88,000 to 90,000	42	840	17,660
90,000 to 92,000	43	860	18,520
92,000 to 94,000	44	880	19,400
94,000 to 96,000	45	900	20,300

Net income	Per cent	Surtax	Total surtax
\$ 96,000 to \$ 98,000	46	\$ 920	\$21,220
98,000 to 100,000	47	940	22,160
100,000 to 150,000	48	24,000	46,160
150,000 to 200,000	49	24,500	70,660
200,000 up	50	......	.....

COMPUTING THE TAX—ILLUSTRATION FOR 1921. The tax on a married person living with husband or wife, with a net income of \$15,000 for the year 1921, assuming that none of such income consists of (a) dividends or (b) interest upon obligations of the United States or bonds issued by the War Finance Corporation, is computed as follows:

	Rate	Amt. of tax
Normal Tax		
\$15,000 minus \$2,000 (personal exemption) equals \$13,000		
First \$4,000 at	4%	\$160
Remaining 9,000 at	8%	720
Surtax		
On first \$5,000	0%	0
On next 1,000 (\$5,000 to \$6,000)	1%	10
On next 2,000 (\$6,000 to \$8,000)	2%	40
On next 2,000 (\$8,000 to \$10,000)	3%	60
On next 2,000 (\$10,000 to \$12,000)	4%	80
On next 2,000 (\$12,000 to \$14,000)	5%	100
On next 1,000 (\$14,000 to \$15,000)	6%	60
	Total	\$1,230

The tax on an unmarried person would be increased by 8% on \$1,000 or \$80, since the personal exemption is \$1,000 less, and the balance of taxable net income over \$4,000 would be increased accordingly. In case the married person or head of a family in the above computation is entitled to further exemption because of persons dependent upon him, the normal tax will be reduced at the rate of \$32 for each such dependent, that is, 8% on \$400.[19] If the above net income were \$5,000 or less, the tax would be computed as follows:

\$5,000 minus \$2,500 (personal exemption)
equals \$2,500 taxed at 4% equals \$100

[19] Revenue Act of 1921, § 216 (d); Revenue Act of 1918, § 216 (d).

COMPUTING THE TAX—ILLUSTRATION FOR 1922. The tax on a married person with a net income of $15,000 for the year 1922, assuming that none of such income consists of (a) dividends or (b) interest upon obligations of the United States or bonds issued by the War Finance Corporation, is computed as follows:

Normal Tax	Rate	Amt. of tax
$15,000 minus $2,000 (personal exemption) equals $13,000		
First $4,000 at................	4%	$160
Remaining 9,000 at................	8%	720
Surtax		
On first $6,000......................	0%	0
On next 4,000...................... ($6,000 to $10,000)	1%	40
On next 2,000...................... ($10,000 to $12,000)	2%	40
On next 2,000...................... ($12,000 to $14,000)	3%	60
On next 1,000...................... ($14,000 to $15,000)	4%	40
	Total	$1,060

Surtax on Stockholders in Respect of Undistributed Profits of Corporations.[20] The surtax is ordinarily assessed only upon income actually received by the taxpayer. But if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate, instead of being divided or distributed, the corporation is subject to an additional income tax of 25%; or if all the stockholders or members agree thereto, the commissioner may, in lieu of all income, war-profits and excess-profits taxes for the taxable year, tax the stockholders or members upon their distributive shares in the net income as the members of a partnership are taxed. This second above alternative is similar to the corresponding provision of the 1918 Law, except that no unanimous consent of stockholders was necessary

[20] It is to be seriously doubted whether this provision of the statute and the corresponding provision of the Revenue Act of 1918 (§ 220) is constitutional, particularly in view of the decision of the Supreme Court in Eisner v. Macomber, 252 U. S. 189. Such expressions as "the substantial difference between corporation and stockholders"; we cannot "look upon stockholders as partners, when they are not such"; we cannot treat stockholders "as having in equity a right to partition of the corporate assets, when they have none"; we cannot "indulge in the fiction that they have received and realized a share of profits, which, in truth, they have never received nor realized." It is only by treating a corporation as an entity

under that law. Under the 1918 Law the excess-profits tax paid by the corporation was deductible from the net income before the computation of the proportionate share of each stockholder or member. It does not seem to be within the discretion of the Commissioner to apply either of the two alternative methods of taxation provided by the Revenue Act of 1921. The stockholders or members may, of course, oblige the Commissioner to resort to the 25% tax by withholding consent. The history of the provision indicates that they may oblige him to use the second alternative by giving consent.[21]

This provision applies only where the accumulation is permitted for the purpose of avoiding the surtax. Ordinarily, the stockholder of a corporation has no need to concern himself with or to make any inquiry as to the undistributed income of the corporation.[22] The 1918 provision applies only to the income of 1918, 1919 and 1920, and cannot be utilized to force a distribution of

separate from its stockholders that a dividend which is paid may be regarded as income. The following remark of the Supreme Court in the same case is also interesting in this connection: "If profits have been made and not divided they create additional bookkeeping liabilities under the head of 'profit and loss', 'undivided profits', 'surplus account', or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose." Neither, it seems, can the tax imposed by this section be sustained as a property tax. The attempt was made to sustain the tax on stock dividends as a tax upon the shareholders upon their property interest in the stock of corporations. The Supreme Court, however, denominated such a tax as a tax upon property which could not be imposed without apportionment. Whether the tax imposed by § 220 is constitutionally justifiable as being in the nature of a penalty is a question which only the courts can satisfactorily determine. These considerations apply equally to the tax imposed by § II-A-2 of the 1913 Law, and § 3 of the 1916 Law. The doubt as to the constitutionality of § 220 of the 1918 Law is the reason for the imposition by Congress of the flat additional tax of 25% on corporations of the above character, with the alternative tax on the stockholders discussed above. (See report of the Revenue Bill of 1921 by the senate committee on finance, p. 16.)

21 Cf. Revenue Act of 1921, § 220, and Revenue Act of 1918, § 220. The provision of the 1918 Law was broader than the provision contained in the 1916 Law, which authorized the commissioner to assess a tax on the shareholders with respect to the undistributed profits only in cases where such profits were allowed to accumulate with fraudulent intent to avoid the surtax. Compare the section with section 3 of the Revenue Act of 1916.

22 See T. D. 2135.

unnecessary surplus accumulated in prior years.[23] The fact that a corporation is in the process of liquidation has been held not to render this provision of the law inapplicable.[24]

The fact that a corporation is a mere holding company,[25] or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business is *prima facie* evidence of a purpose to escape the surtax. The collectors, however, have no authority to decide when gains and profits are accumulated beyond the reasonable needs of the business so as to be taxable as indicated above. The commissioner must first certify that in his opinion the accumulation is unreasonable.[26] In any case the commissioner or a collector may require a corporation to furnish a statement of its gains and profits and of the names, addresses, and shareholdings of the stockholders, and if upon the basis of such statement or other evidence the commissioner certifies that in his opinion its accumulation of profits is unreasonable for the purposes of the business, the corporation and its stockholders must make their returns accordingly.[27] Under the 1918 law, when the commissioner had so certified, the stockholders were notified and called upon to add the amount of their respective shares in the undistributed gains and profits of the corporation for the year to their income from other sources and to pay the surtax accordingly.

PURPOSE TO ESCAPE SURTAX. The application of the rule stated in the foregoing paragraph depends upon the two elements of (a) purpose to escape the surtax and (b) unreasonable accumulation of gains and profits. *Prima facie* evidence of (a) exists where a corporation has practically no business except holding stocks, securities or other property and collecting the income

[23] O. D. 188, T. B. 8-19-326. To such unnecessary accumulations, however, the provisions of the Acts of October 3, 1913, September 8, 1916, and October 3, 1917, will be applicable according to the respective years in which such acts were in effect and such portions of the surplus were accumulated. The applicable provision of the Act of September 8, 1916, is § 3 and not § 10 (b) added by the Revenue Act of 1917, which provided for a tax on the undistributed income of corporations without reference to whether such earnings were accumulated with a fraudulent purpose of preventing the imposition of the surtaxes.

[24] O. D. 838, T. B. 10-21-1499.

[25] "A mere holding company" within the meaning of this provision of the law would seem to be a company which does nothing but hold the stock of other corporations, or which merely holds or acts as a receptacle for property and which is not actively engaged in business. (A. R. R. 475, T. B. 21-21-1653.)

[26] Revenue Act of 1921, § 220; Revenue Act of 1918, § 220.

[27] Reg. 45, Art. 351.

therefrom, or where a corporation other than a mere holding company permits its gains and profits to accumulate beyond the reasonable needs of the business.

Both the Revenue Act of 1921 and the Revenue Act of 1918 require that a corporation be "formed" or "availed of" for the purpose of preventing the imposition of the surtax. The statutes differ from prior laws in that they do not specifically require that a corporation be "fraudulently" availed of.[28] It is to be doubted, however, whether this distinction is not more apparent than real.[29] In any event, however, it should be remembered that there is a presumption against fraud. Good faith is presumed and the burden of proving fraud is on the party asserting it.[30] The evidence by which fraud or a fraudulent purpose may be proved should be clear and unequivocal and should not admit of any innocent construction. The certificate by the commissioner that in his opinion the accumulation of profits of a corporation is unreasonable can have no greater probative force than the facts upon which it is predicated and is certainly open to rebuttal by evidence to the contrary.

The business of a corporation is not limited to that which it has previously carried on, but in general includes any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business.[31]

[28] See footnote 21, and also cf. Revenue Act of 1921, § 220; Revenue Act of 1918, § 220; Revenue Act of 1913, § II-A-2.

[29] See § 252 of the 1918 and 1921 Laws, which prescribe a penalty for any wilful attempt to defeat or evade the tax "*in any manner*".

[30] Sanborn v. Stetson, 21 Fed. Cas. 12, 291, 2 Story, 481; Matter of Green, 67 Hun. 527, 20 N. Y. Supp. 538, affirmed 22 N. Y. Supp. 1112.

[31] Reg. 45, Art. 352.

Unreasonable Accumulation of Profits. An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business.[32] Whether a corporation is unreasonably accumulating its profits cannot be determined in advance; it must be determined at a later date in the light of what has actually been done with the profits retained.[33] The question is one of fact to be decided upon consideration of the volume of business done and the principles of sound business management.[34] In determining what are the reasonable needs of a business, the general rule is applicable that the amount of capital necessary to accomplish the objects of a business is a matter largely in the discretion of the directors of a corporation, particularly directors who may be, by reason of many years of service, particularly familiar with the requirements of a business. The exercise of the discretion of such directors will not be disturbed in the absence of a clear or gross abuse thereof.[35] Where a company has been in existence for a long period, part of which antedates the imposition of the surtax with respect to undistributed corporate profits and a conservative dividend policy has been pursued prior to the enactment of the tax on undistributed corporate profits, this fact will be important in determining whether there is any unreasonable accumulation of profits.[36] A retirement of capital stock indicates that additional capital is not required by a corporation and if upon such a retirement surplus is permitted to stand, such surplus will be deemed an unreasonable accumulation.[37] Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation.

[32] Reg. 45, Art. 353.

[33] T. B. M. 2, T. B. 1-19-72.

[34] S. 1117, T. B. 15-19-448. The fact that a corporation having a capital of $10,000 and doing an annual business in excess of $150,000, has an accumulation of $55,000 in undivided profits, is not sufficient basis for the finding that there has been an unreasonable accumulation of profits.

[35] See Cook on Corporations, 5th edition, § 545. Kester on "Accounting Theory and Practice", Vol. II, p. 210. Schell v. Alston Mfg. Co., 149 Fed. 439.

[36] See A. R. R. 475, T. B. 21-21-1563.

[37] O. D. 360, T. B. 2-20-667.

In the case of a banking institution the business of which is to receive and loan money, using capital, surplus and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business.[38]

[38] Reg. 45, Art. 353. In connection with the interpretation of the phrase "reasonable needs of the business," see the interpretation placed upon the phrase "reasonable requirements of business", as used in § 10-b of the 1916 Law. (See T. D. 2736.)

CHAPTER 3.

INDIVIDUALS TO WHOM THE LAW IS APPLICABLE

The theory upon which the income tax is imposed seems to be two-fold. The law imposes the tax upon the net income of all persons within its jurisdiction, regardless of the source of such income, and upon all income arising from sources within the United States, regardless of whether or not the United States has jurisdiction of the recipient. The tax has been defined as a tax on the person, measured by his ability to pay, that is, his net income,[1] and as a tax on the income itself.[2] As a matter of fact, it is both. The government claims personal jurisdiction over all of its citizens wherever they reside and over all aliens who reside within the borders of the United States. Hence, as to citizens and resident aliens, the tax is imposed on income from all sources whether arising in this country or in a foreign country.[3] No jur-

[1] In Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 564, the court said: "In our opinion the tax is against the citizens and residents of the United States personally. They are chargeable in respect to income received by them." In State ex rel, Moon Co. v. Wisconsin Tax Commission 166 Wis. 287; 163 N. W. 639; 165 N. W. 470, appeal dismissed by U. S. Supreme Court, 249 U. S. 621; the court said: "Much confusion of thought arises from regarding the income tax as a tax that is levied upon or attaches to property as such, irrespective of the person sought to be taxed. It is the recipient of the income that is taxed, not his property; and the vital question in each case is, has the person sought to be taxed received an income during the tax year? If so, such income, unless specifically exempted, is subject to a tax though the property out of which it is paid may have been exempt from an income tax in the hands of the payer. It is the relation that exists between the person sought to be taxed and specific property claimed as income to him that determines whether there shall be a tax. If the person sought to be taxed is the recipient during the tax year of such specific property as income in its ordinary significance, then the person is taxed. But the tax is upon the right or ability to produce, create, receive, and enjoy, and not upon specific property. Hence the amount of the tax is measured by the amount of the income, irrespective of the amount of specific property or ability necessary to produce or create it. In the ordinary acceptation of the term this may be said to be a tax upon income as the statute denominates it. But the tax does not seek to reach property, or an interest in property as such. It is a burden laid upon the recipient of an income."

[2] In a case decided by the Supreme Judicial Court of Massachusetts, Suter v. Jordan-Marsh Company, 225 Mass. 34., 113 N. E. 580, it was held that the tax was levied upon the rent paid by the defendant to the plaintiff. See also Catawissa R. Co. v. Phila. & Reading Co., 255 Pa. St. 269, 99 Atl. 807.

[3] This is generally true; the 1921 Law, however, contains a provision that the gross income of citizens and domestic corporations with a substantial pro-

isdiction can be claimed over the persons of nonresident aliens, but insofar as their income is received from sources within this country, it is taxed on the theory that the government has jurisdiction over the income, grants protection to the creation of such income, and is, therefore, entitled to a share thereof to defray the expenses of government.[4] The fact that a person is taxable in foreign countries on all or part of his income does not relieve him from tax liability on the same income in this country,[5] although he is entitled under the Revenue Act of 1921 and the Revenue Act of 1918, to a credit in certain cases against his tax liability in this country by reason of the payment of taxes to foreign countries.[6]

Persons Exempt from the Tax. Individuals may enjoy exemption from the income tax by reason of the *amount* or *character* of their income.

EXEMPTION BASED ON AMOUNT OF INCOME. Citizens and residents receiving less than $1,000 of net income during the year, if single, or less than $2,500, if the head of a family or a married person living with husband or wife, are exempt from the tax. Such persons are not required to file returns, unless they have a gross income of $5,000 or over, or, if husband and wife, an aggregate gross income of $5,000 or over. But on demand of the commissioner they may be required to file a statement sufficient to satisfy him that they are not liable.[7] Nonresident aliens and citizens deriving a substantial proportion of income from sources within a United States possession are allowed a personal exemption of $1,000 on income received from sources within the United States if they file the required returns.[8]

portion of income from sources within United States possessions shall be limited to income from United States sources (Revenue Act of 1921, § 262).

[4] Reg. 45, Art. 3. See Union Transit Co. v. Kentucky, 199 U. S. 194; Maguire v. Trefry, 253 U. S. 12, 230 Mass. 503, 120 N. E. 162.

[5] T. D. 2152.

[6] Revenue Act of 1921, §§ 222, 238; Revenue Act of 1918, §§ 222, 238. This credit against a person's tax should not be confused with the deduction of taxes in order to determine net income.

[7] Revenue Act of 1921, §§ 223, 1307. Under the 1918 Law a married person was exempt only to the extent of $2,000; and that law determined whether a return should be filed on the basis of net, not gross, income in all cases (Revenue Act of 1918, §§ 223, 1305).

[8] Revenue Act of 1921, §§ 216 (e), 217 (g). Under the 1918 Law, nonresident aliens were allowed a personal exemption of $2,000 provided the country of which they were subjects, if it imposed an income tax, allowed a similar credit to citizens of the United States.

EXEMPTION BASED ON CHARACTER OF INCOME OR STATUS OF RECIPIENT. Individuals may also enjoy an exemption from the tax because of the character of their income, or because of their status, or both, since the law expressly provides that certain kinds of income shall not be included in gross income and shall be exempt from the tax. Among the items of income so exempt[9] are: (a) the proceeds of life insurance policies paid upon the death of the insured;[10] (b) the amount received by the insured as return of premiums paid by him under life insurance, endowment or annuity contracts; (c) property acquired by gift, bequest, devise or descent (but the income from such property is taxable); (d) amounts received through accident or health insurance or under Workmen's Compensation Acts as compensation for personal injuries or sickness and the amount of any damages received whether by suit or agreement on account of such injuries or sickness; (e) the income of a nonresident alien or foreign corporation consisting exclusively of earnings derived from the operation of ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States; (f) compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Act, or pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war;[11] (g) so much of the amount received by an individual after December 31, 1921, and before January 1, 1921, as interest or dividends from domestic building and loan associations[12] operated exclusively for the purpose of making loans to members,

[9] Revenue Act of 1921, § 213 (b); Revenue Act of 1918, § 213 (b).

[10] Such proceeds must be paid "to individual beneficiaries, or to the estate of the insured," under the 1918 Law.

[11] Such compensation was taxable under the Revenue Act of 1918 (letter from treasury department dated April 7, 1921; I. T. S. 1921, ¶ 2975). The term "active services" is used in the sense of services in all military and naval branches at home or abroad, as contradistinguished from the retired or reserve list and is not confined merely to services in the field or the theatre of war. The term "military or naval forces" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female, but this definition does not exclude other units otherwise included (Revenue Act of 1921, § 2 [10]). The term also includes army contract surgeons, but does not include members of draft boards. (Reg. 45, Art. 86.) It does not include the Public Health Service (T. D. 3242). Under the 1918 Law, so much of the amount received during the war with Germany by a person in the military or naval forces as salary or compensation in any form from the United States for active services in such forces, as did not exceed $3,500, was exempt.

[12] For a definition of building and loan associations see Chapter 13.

as does not exceed $300; and (h) the rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation. Income derived from the operation of a public utility and the receipts of shipowners' mutual protection and indemnity associations is also exempt to a certain extent and under certain conditions, as is indicated more fully in another chapter.[13] Interest upon (1) the obligations of a state, territory or any political subdivision thereof, the District of Columbia, or any possession of the United States, (2) securities issued under the provisions of the Federal Farm Loan Act, (3) the obligations of the United States, issued prior to September 1, 1917, is exempt. The interest upon obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit) and bonds issued by the War Finance Corporation is exempt only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented, and may be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under the income and excess-profits taxes.[14] The 1916 Law expressly exempted the compensation of the present President of the United States, during the term for which he has been elected, and the compensation of the judges of the Supreme Court and inferior courts of the United States, in office at the time the Act was passed, but the Revenue Act of 1921, and the Revenue Act of 1918 expressly tax the compensation received as such of the President, the judges of the Supreme Court and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia.[15] Neither the Revenue Act of 1921 nor the Revenue Act of 1918 expressly exempts "the compensation of all officers and employees of a state, or any political subdivision thereof, except when such compensation is paid by the United States Government,"[16] as did the 1916 law. It seems to have been the intent of congress in the present statute and the 1918 Law to tax such salaries and to leave the constitutional

[13] See Chapter 14.

[14] Revenue Act of 1921, §§ 213 (b) 4, 233; Revenue Act of 1918, §§ 214 (b) 4, 233.

[15] Revenue Act of 1916, §4. But see Chapter 15.

[16] Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a). The constitutional question involved in taxing such salaries is discussed in Chapter 15.

question involved in levying the tax to the courts,[17] but the treasury department has ruled that compensation paid to its officers and employees by a state or any political subdivision thereof, will not be taxed.[18] Exempt income is omitted from the returns of individuals and corporations,[19] but income exempt only from normal tax and not from surtax, or from the income tax, but not from the excess-profits tax, must be included in the return.

Citizens of the United States. Citizens of the United States are ordinarily taxable upon their net income from *all* sources, whether they reside in this country or not.[20] With the exception of citizens deriving a substantial proportion of their income from sources within a possession of the United States, it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States.[21] They are taxable for the purpose of the *surtax* upon their entire net income received in each year from all sources and for the purpose of the normal tax upon net income less statutory credits.[22] Income wholly exempt is not included in gross income, the foundation for the computation of net income.[23] On dividends of domestic and certain foreign corporations they are liable only for the surtax; and so also with respect to interest on bonds of the United States issued after September 1, 1917, and bonds of the War Finance Corporation.[24] The regulations and rulings respecting taxable and nontaxable income are, as a rule, applicable both to individuals and corporations, and are discussed in detail in the later chapters on income.[25]

[17] Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a). The constitutional question involved in taxing such salaries is discussed in Chapter 15.

[18] Reg. 45, Art. 85. This subject is more fully discussed in Chapter 15.

[19] Reg. 45, Art. 71. The exclusion of such income should not be confused with the reduction of taxable income by the application of allowable deductions.

[20] In U. S. v. Goelet, 232 U. S. 293, the court held that a United States citizen permanently residing or domiciled aboard was not liable to the tax on foreign-built yachts imposed by the tariff act of August 5, 1909. The court said that "the taxing power, when exerted, is not usually applied to those even albeit they are citizens, who have a permanent domicile or residence outside of the country levying the tax."

[21] Reg. 45, Art. 3. See Revenue Act of 1921, § 262.

[22] Reg. 45, Art. 21.

[23] Revenue Act of 1921, §§ 213, 212; Revenue Act of 1918, §§ 213, 212; Reg. 45, Art. 21.

[24] Revenue Act of 1921, § 216; Revenue Act of 1918, § 216.

[25] See Chapters 14-20.

Who Is a Citizen. Every person born in the United States subject to its jurisdiction, or naturalized in the United States, is a citizen. An individual born in the United States of citizen or resident alien parents, who has long since moved to a foreign country and established a domicile there, but who never has been naturalized therein or taken an oath of allegiance thereto is still a citizen of the United States.[26] Married women are considered to have the same citizenship as their husbands. An American woman who marries a foreigner consequently loses her status as an American citizen and is thereafter treated as an alien.[27] Determination by the state department of the status of an individual is not conclusive upon the treasury department in fixing citizenship for income tax purposes.[28] Under the naturalization laws of the United States, the naturalization of a father operates to confer the right of citizenship upon his minor child, who is dwelling at the time of the father's naturalization within the jurisdiction of the United States or who dwells within that jurisdiction subsequent to the father's naturalization and during the child's minority. If, after attaining his majority, the son returns to his native land, but registers with the American consul under the rules and regulations prescribed by the department of state as an American citizen residing abroad, his status under American law is that of an American citizen. A minor, an alien by birth, living with and subject to the authority and guardianship of a mother who became an American citizen by marriage, the minor having been physically present in the United States at the time of such marriage, and the mother at that time having intended this country to be the minor's permanent place of residence or domicile, is an American citizen and cannot elect another nationality or expatriate himself while he is a minor. No election which he may make after his majority will affect his status as a citizen during his minority.[29] A naturalized citizen, over the age of majority, who takes an oath of allegiance to a foreign government has expatriated himself.[30] He does not become repatriated by subsequently applying to an American consul for registration as an American citizen residing abroad, even though his registration is accepted by the department of state. The oath of allegiance taken upon such registration is

[26] Reg. 45, Art. 4.

[27] T. D. 2092.

[28] T. D. 2135.

[29] O. D. 695, T. B. 43-20-1256; O. D. 1085, T. B. 44-21-1897.

[30] See Act of March 2, 1907, § 2.

not the one prescribed by the naturalization law and regulations. which oath must be taken as a condition to repatriation.[31]

CITIZENS RESIDING IN THE UNITED STATES. Citizens residing in the United States report and pay the tax in the district in which they legally reside or have their principal place of business, regardless of where their income may arise.[32]

CITIZENS RESIDING ABROAD. If a citizen residing abroad has no office or place of business in this country, he files his return and pays his tax to the collector at Baltimore, Maryland.[33] With the exception indicated in the next paragraph, he is required to report his income from all sources, whether within or without the United States. Income received by a citizen of the United States residing abroad from foreign sources in foreign money or credits should be reported in terms of United States money on the basis of the rate of exchange in effect at the time it was actually received.[34] Although the question as to the liability of a nonresident citizen is determined by the treasury department, not by the state department, still, in the case of a *naturalized* citizen against whom the presumption of expatriation has arisen, the fact that he has paid the income tax will receive due consideration by the state department in connection with other evidence submitted to overcome such presumption in connection with applications for passports or for registration in a consulate or for actual protection in a foreign country. The payment of the income tax will also be duly considered by the state department in passing upon rights to the continued protection of this government in cases of *native* American citizens who have resided abroad for a period sufficiently prolonged to raise the natural presumption that they have abandoned citizenship in this country.[35]

CITIZENS DERIVING INCOME FROM UNITED STATES POSSESSIONS. Citizens who for three years immediately preceding the close of the taxable year derive 80% or more of their gross income from sources within a possession of the United States and 50% for the same period from the active conduct of a trade or business within a possession of the United States, either on their

[31] See Act of May 9, 1918, § 4; O. D. 861, T. B. 14-21-1540.

[32] Revenue Act of 1921, § 227 (b); Revenue Act of 1918, § 227 (b); Reg. 45, Art. 448.

[33] Revenue Act of 1921, § 227 (b); Revenue Act of 1918, § 227 (b).

[34] O. D. 459, T. B. 16-20-873. For the rates of exchange prevailing on various dates, see Chapter 14.

[35] Letter from secretary of state to American diplomatic and consular officers, dated March 18, 1914; I. T. S. 1918, ¶ 5; Revenue Act of 1918, § 227 (b).

own account or as employees or agents of another, are treated as nonresident aliens under the Revenue Act of 1921, except that all amounts received by such citizens within the United States, whether derived from sources within or without the United States, must be included in their gross income.[36]

Aliens Residing in the United States. All residents of this country, even though they may be aliens, are generally classified with citizens of the United States for the purpose of income tax, and are taxable upon their entire net income from all sources.[37] Where a nonresident alien taxpayer becomes a citizen or resident of the United States during the taxable year, he is taxable for the entire year upon income derived from all sources.[38] The question whether or not an alien resides in this country is sometimes difficult to determine. The Treasury Department holds that the term "nonresident alien individual" means an individual (a) whose residence[39] is not within the United States, and (b) who is not a citizen of the United States. Any alien actually present in the United States, who is not a mere transient or sojourner, is a resident of the United States for purposes of the income tax. Whether he is a transient or not is determined by his intentions with regard to his stay and the length and nature of his stay. If he lives in the United States and has no definite intention as to his stay, he is a resident. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned.

PROOF OF RESIDENCE OF ALIEN. The following rules of evidence will govern in determining whether or not an alien within

[36] Revenue Act of 1921, § 262. The Virgin Islands are not a possession of the United States within the meaning of this provision.

[37] Reg. 45, Art. 3.

[38] O. 785, T. B. 1-19-66.

[39] The treasury department has adopted the following definition of the word "residence" as used in the income tax laws: "That place where a man has his true, fixed and permanent home and principal establishment, and to which, whenever he is absent, he has the intention of returning; and indicates permanency of occupation as distinct from lodging or boarding, or temporary occupation." (T. D. 2242.)

the United States has acquired residence therein. An alien, by reason of his alienage, is presumed to be a nonresident alien. Such presumption may be overthrown (1) in the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (a) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1078 (revised) or its equivalent with the withholding agent charged with the duty of withholding the tax on income paid to nonresident aliens, or (c) proof of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States had been of such an extended nature as to constitute him a resident; (2) in all other cases by (a) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien has filed Form 1078 (revised) or its equivalent, or (c) proof of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident. In any case in which an alien seeks to overcome the presumption of nonresidence under (1) (c) or (2) (c) above, if the officer who examines the alien is in doubt as to the facts, such officer may, to assist him in determining the facts require an affidavit or affidavits setting forth the facts relied upon, executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months prior to the date of execution of the affidavit or affidavits.[40]

Loss of Residence by Alien. An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the

[40] Reg. 45, Arts. 312 and 313, as amended by T. D. 3155, T. B. 17-21-1599; Reg. 45, Art. 362; T. D. 2794; T. D. 2242. See O. D. 127, T. B. 3-19-195. This rule differs from the English rule which provides that a person within the United Kingdom, for some temporary purpose only, for less than six months during the year, is not taxable as a resident, but after a residence of six months he becomes chargeable with the duties for the year commencing on April 6th preceding.

United States. The status of an alien on the last day of his taxable year or period determines his liability to tax for such year or period as a resident or nonresident.[41] A British citizen, a member of a British partnership, who is within the territorial limits of the United States seven or eight months of the year for the purpose of transacting business for the partnership and who returns to Europe when the purpose which necessitates his presence in the United States is accomplished is considered a nonresident alien.[42] The fact that Germans who were resident aliens of the United States prior to the war with Germany were registered as alien enemies will not deprive them of their status as residents if the conduct, acts, and declarations of the aliens indicate their intention to maintain their status as residents.[43] The treasury department holds that residence in the United States by an alien for as much as one year establishes a presumption that such alien is a resident of the United States and this presumption will be indulged in the absence of known facts showing that the alien is in fact a transient.[44] The distinction between resident and nonresident aliens is also discussed elsewhere in this book.[45]

Nonresident Aliens.[46] Nonresident aliens are those individuals who are neither citizens nor residents of this country.[47] As stated above, they are taxable only on that part of their income which is from sources within the United States.[48]

Taxation of Individuals Between United States and Porto Rico and Philippine Islands. A citizens of the United States who resides in Porto Rico, and a citizen of Porto Rico who resides in the United States, may be taxed in both places, but the income tax in the United States may be credited with the amount of any income, war-profits and excess-profits taxes paid in Porto Rico. If a resident of the United States, who is not a citizen of Porto Rico, is taxed in Porto Rico, as a nonresident alien individual on any income derived from sources within Porto Rico, the income tax in the United States may be credited with the tax paid in Porto Rico. A resident of Porto Rico, who is not a citizen of the United States, is taxable in the United States as a nonresident alien individual on any income derived

[41] Reg. 45, Art. 314, as amended by T. D. 3155, T. B. 17-21-1599.

[42] O. D. 592, T. B. 29-20-1072.

[43] O. D. 400, T. B. 6-20-731.

[44] O. D. 197, T. B. 9-19-342.

[45] See Chapter 4.

[46] The term "nonresident alien" is defined more fully in Chapter 4.

[47] Reg. 45, Art. 312; O. D. 333, T. B. 28-19-619.

[48] Revenue Act of 1921, §§ 213 (c), 217; Revenue Act of 1918, § 213 (c).

from sources within the United States, and receives no credit. The same principles apply in the case of the Philippine Islands.[49] But citizens of the United States who have derived for a three-year period preceding the close of the taxable year, 80% of their gross income from sources within a possession of the United States and 50% of their gross income from the active conduct of a trade within a United States possession, may be taxed, as to the United States, as nonresident aliens.[50]

Husband and Wife. In so far as possible the family is treated as a unit for purposes of the income tax, and the husband and wife may make joint returns.[51] The matter of filing returns by husband and wife is treated more fully in another chapter,[52] except as to the effect of the "community property system" which is treated below.

"COMMUNITY" PROPERTY AND INCOME OF HUSBAND AND WIFE. What is known as the "community property system" prevails in Texas, Arizona, California, Washington, Louisiana, Idaho, Nevada and New Mexico. It seems to have had its origin in France and Spain and to have been brought thence into the judicial systems of the above states. Community property laws provide generally that all property acquired during marriage by the industry and labor of either husband or wife, or both together, with the produce and increase thereof, belongs to both in equal shares during the continuance of the marital relation.[53] The foundation of this community property system lies in the fact or the legal assumption that all property acquired during marriage otherwise than by gift, devise or descent, is acquired by the joint efforts of husband and wife.[54] Their relation partakes of the nature of a partnership in which each partner may have separate assets or property as well as common stock of acquisitions and gains. The business of the firm generally is transacted in the name of the husband and

[49] Revenue Act of 1921, § 222; Reg. 45, Art. 1132; Lawrence v. Wardell, 270 Fed. 682, affirmed 273 Fed. 405. See Chapter 32.

[50] See Chapter 4 for a full discussion of this subject.

[51] Revenue Act of 1921, § 223; Revenue Act of 1918, § 223.

[52] See Chapter 34.

[53] See Tucker v. Carr, 39 Tex. 98; Cooks v. Bremond, 27 Tex. 457; Fennell v. Drinkhouse, 131 Cal. 447, 63 Pac. 734; Washburn v. Washburn, 9 Cal. 475; Succession of Webre, 49 La. Ann. 1491, 22 So. 390; Knight v. Kaufman, 105 La. 35, 29 So. 711; Manning v. Burke, 107 La. 456, 31 So. 862; Abbott v. Wetherby, 6 Wash. 507, 33 Pac. 1070; Yake v. Pugh, 13 Wash. 78, 42 Pac. 528; Sherlock v. Denny, 28 Wash. 170, 68 Pac. 452; Cline v. Hackbarth, 27 Tex. Civ. App. 391, 65 S. W. 1086; Johnson v. Burford, 39 Tex. 242; Pearce v. Jackson, 61 Tex. 642.

[54] Nickerson v. Nickerson, 65 Tex. 281.

he prosecutes and defends its suits with the same effect as if his partner were named in the case,[55] and, although community property has not all the incidents of partnership property, it has many of them and is commonly spoken of as partnership property.[56] In a conventional partnership the gains of the partners are in proportion to their respective shares of stock and services, but in the conjugal partnership implied in the community property system, the division is equal although one spouse may have brought in the greater part if not all of the property from which the profits are derived or may have contributed all his or her skill and services unaided by the other.[57] The fact that one or the other of the spouses may do all the work does not change the character of community property[58] and though the management and disposal of community property during marriage are usually given to the husband, this is said to be for reasons of public policy and social economy and not on the ground that the husband has any greater interest in it than the wife.

It appears that in all of the community-property states except California their own courts have held that the wife has, during the existence of the marriage relation, a vested interest in one-half of the community property. Her rights in the property of the community are perhaps most fully recognized in the state of Washington, where both spouses have testamentary disposition over one-half of the community property, and where, in the absence of such disposition, it descends to their issue, or, in the absence of issue, to the survivor; while the husband is manager of the community estate in Washington he may not sell, convey, or encumber real estate unless the wife join with him in the conveyance; and the separate debt of the husband cannot be satisfied out of community property where it is not incurred in connection with the community business, nor for the benefit of the community.[59]

[55] Simpson v. Brotherton, 62 Tex. 170.

[56] De Blanc v. Lynch & Co., 23 Tex. 25; Wilkinson v. Wilkinson, 20 Tex. 237; Holyoke v. Jackson, 3 Wash. Terr. 235, 3 Pac. 841.

[57] Wheat v. Owens, 15 Tex. 241; Routh v. Routh, 57 Tex. 589; Merrell v. Moore, 47 Tex. Civ. App. 200, 104 S. W. 514; Edwards v. Brown, 68 Tex. 329; Saunders v. Isbell, 5 Tex. Civ. App. 513, 24 S. W. 307; Barr v. Simpson, 54 Tex. Civ. App. 105, 117 S. W. 1041; Wright v. Hays' Admr., 10 Tex. 130; Zimpelman v. Robb, 53 Tex. 274; T. D. 2450.

[58] Yates v. Houston, 3 Tex. 433.

[59] Pierce's Washington Code of 1919, § 1424-6. Holyoke v. Jackson, 3 Wash. T. 235; Mabie v. Wittaker, 10 Wash. 656, 39 Pac. 172; Martson v. Rue, 92 Wash. 129, 159 Pac. 111; Schramm v. Steele, 97 Wash. 309, 166 Pac. 634; Huyvaerts v. Roedtz, 105 Wash. 657, 178 Pac. 801.

In *Idaho* the limitation upon the alienation of the community real property is the same as in Washington. But while the wife's earnings and the rents and profits of her separate estate are community property she is given the management and control of same. The Idaho rule governing the disposition of community property on the death of either spouse is, with minor variations, the same as that of Washington. In neither state is an inheritance tax payable on the one-half of the community that goes to the one spouse on the death of the other.[60]

In *Arizona* the husband only may dispose of community personal property, but the wife must join him in deeds or mortgages affecting real estate, except unpatented mining claims. One-half of the community property is subject to the testamentary disposition of either spouse, and in absence of such disposition goes to his or her descendants; where there is neither testamentary disposition nor descendants it is subject to distribution in the same manner as the separate property of the husband. On decree of divorce the court may divide the property as it sees fit, but in the absence of provision for the community property the parties from the date of the decree hold as tenants in common. The courts of Arizona hold that the wife is equal owner with her husband.[61]

In *Nevada*, the husband has the entire management and control of the community property, except that the wife has entire control of her earnings when living separate from her husband. Upon her death the husband takes the whole community estate, except that where he has abandoned her without good cause she may by will dispose of half and in absence of such disposition it goes to her heirs, exclusive of her husband. On the death of the husband the wife takes half and the husband may dispose of the other half by will, or it goes to his surviving children; if there is no will and no children survive, the whole goes to the wife without administration, subject to certain provisos. On dissolution of community by divorce for any other ground than adultery or extreme cruelty, the community property must be equally divided between the parties. The wife pays no inheritance tax under the inheritance tax law of Nevada on her interest in community property, the courts holding that she takes not as heir but by a right vested in her at all times

[60] Compiled statutes of Idaho, Art. 4656, 4659, 4666 as Amended by the Laws of 1913; Art. 4667 enacted in 1915. Ewald v. Hufton, 31 Idaho 373, 173 Pac. 247; Kohny v. Dunbar, 21 Idaho 258, 121 Pac. 544.

[61] Civil code of Arizona, Art. 1100, 2061, 3848, 3850. La Tourette v. La Tourette, 15 Ariz. 200, 137 Pac. 426.

during marriage. It is to be noted that the constitution of Nevada recognizes the wife's interest in community property.[62]

In *New Mexico,* while the husband is manager of the community estate, he may not transfer real property without a valuable consideration without the written consent of his wife; and under certain circumstances the wife may be substituted as manager; prior to 1915 he could not transfer community personal property except for a valuable consideration without her written consent; on dissolution of the community by the death of the wife the husband takes all except such portion as may have been set aside to the wife by judicial decree, which portion goes to her heirs unless she has disposed of same by will; on death of the husband one-half goes to the wife and the other half is subject to testamentary disposition by the husband. If he makes no will one-fourth of his one-half goes to the wife and the remainder to the children. On separation either may petition for division of community property and after divorce continue to hold as tenants in common where no disposition has been made in the divorce decree. New Mexico has no state inheritance tax act.[63]

In *Louisiana* the community property comprehends all property acquired during the marriage by either husband or wife except that acquired with separate funds or by inheritance or particular donation, and excepting the earnings of the wife when she is living separate from her husband; the husband is manager of the community, but he may not convey community immovables by gratuitous title, and can not dispose of movables in fraud of the wife; either spouse may dispose of one-half the community property by will and the laws governing the descent of such property in the absence of testamentary disposition apply equally to both spouses, the survivor taking the deceased spouse's half by inheritance when there is no will, and neither father, mother, or descendants. The survivor pays no inheritance tax on his or her one-half of the community property, but does pay on that part inherited from the deceased spouse.[64]

[62] Revised laws of Nevada, §§ 2155-6, 2160, 2164-5. In re Williams, 40 Nev. 241, 161 Pac. 741.

[63] Compiled statutes of New Mexico, §§ 2757-8, 2764-5, 2766 as amended in 1915, 2767, 2770, 2774, 2781, 1845, 1841. Beals v. Ares, 25 N. Mex. 459, 185 Pac. 780.

[64] Revised civil code of Louisiana, Arts. 915-6 as amended in 1920; Arts. 2332-4, 2385-6, 2399, 2402, 2404, 2406. Succession of May, 120 La. 692, 45 So. 551. Dixon v. Dixon's Executors, 4 La. 188; Beck v. Natalie Oil Co., 143 La. 153, 78 So. 430; Succession of Marsal, 118 La. 212, 42 So. 778.

In *Texas* the control of community property is divided between the husband and wife; in that state on the death of either spouse without issue the survivor takes the whole and where there is issue, takes one-half, the other half going to said issue or their descendants. Under the state inheritance tax law the wife pays no tax on her half of the community property.[65]

In *California* the wife has no power of testamentary disposition of community property except of such as may have been set aside to her by judicial decree; she takes one-half as heir on the death of the husband; but on the death of the wife the entire community property belongs to the husband without administration. The California courts have held that under the law as it stood prior to 1917 the wife had no vested interest in community property prior to the dissolution of the marriage.[66]

Basing his conclusion upon the several state decisions interpreting state laws governing property rights, the attorney-general has decided that in Washington, Arizona, Idaho, New Mexico, Louisiana, Texas and Nevada, the husband and wife domiciled therein rendering separate income tax returns may each report as gross income one-half of the income which, under the laws of the respective states becomes, simultaneously with its receipt, community property; that this is not based upon any statute enacted subsequent to March 1, 1913, and applies under the income tax acts prior to the Revenue Act of 1918, as well as that act.[67]

[65] Under the Laws of Texas it has been held that—(1) The earnings of husband and wife belong to them jointly in equal shares; (2) The community interest attaches as soon as the right to the wage comes into existence; and (3) The increase and revenues from the *separate* property of each spouse (except the increase, rents and revenues from lands) is also community property in which the interests of husband and wife are equal. (Tannehill v. Tannehill (Tex. Civ. App.), 171 S. W. 1050). This before the amendment of § 4621 in 1917 made the rents from separate lands the separate property of the owner of the land (Barr v. Simpson, 54 Tex. Civ. App. 105, 117 S. W. 1041; Hayden v. McMillan, 4 Tex. Civ. App. 479, 23 S. W. 430.) It has therefore been ruled that:—(1) The *earnings* of husband and wife and the revenues from their *community property and separate personal property* are community income under the provisions of the Revenue Act of 1918; and (2) That the husband and wife in rendering separate income tax returns may each report as gross income one-half the total—(a) Earnings of the husband and wife; (b) Income from separate property; and (c) Income from community property. (T. D. 3071, T. B. 39-20-1218.)

[66] Civil code of California, §§ 162-4, 172-172(a), 1401-2; Spreckels v. Spreckels, 116 Cal. 339, 48 Pac. 228; Estate of Moffitt, 153 Cal. 359, 95 Pac. 653, 1025; Moffitt v. Kelly, 218 U. S. 400.

[67] T. D. 3138, containing opinion of attorney-general, dated February 26, 1921, T. B. 11-21-1515; T. D. 3071 containing opinion of attorney-general,

In returns in which community income is divided between husband and wife domiciled in states where such income is divisible for income tax purposes, both husband and wife should report in detail the gross income from such community property. The deductions properly chargeable against such income should be equally divided between husband and wife.[68] Where a husband and wife, domiciled in a state other than a community property state, purchase lands located in Texas with the separate funds of one of the spouses, the rents and revenues therefrom constitute the income of the spouse whose funds purchased the land, and are so returnable; and where a husband and wife, domiciled in a state other than a community property state, purchase land located in the state of Texas with funds furnished in part by the husband and in part by the wife, then the rents and revenues are income of each in proportion to their interest in the land and are so returnable. This is so though the spouses thereupon become domiciled in the state where the land is situated.[69] Where husband and wife acquire community property while domiciled in the state of Idaho, and then take up domicile in California, they may continue to render separate returns of the income from such property, since the wife has a vested interest in the property, which is not affected by change of domicile.[70] When a husband and wife acquire with community earnings real property in the state of Washington while domiciled therein and then move to another state, the wife's interest is not affected and they may file separate returns in which the income from community property in Washington is divided between them.[71] The guardian of a taxpayer, *non compos mentis*, whose legal domicile is Texas, and whose wife has been maintaining a residence in Virginia since prior to the enactment of the income-tax law, may, if the marital relation has not been dissolved, report one-half of the income from the property which is within the state of Texas.[72]

dated August 24, 1920, T. B. 39-20-1218; modifying O. D. 285, T. B. 21-19-528 and O. D. 426, T. B. 13-28-15. See also A. R. R. 403, T. B. 10-21-1492. In California a wife may not include in her separate return salary and wages received by her. (O. D. 1128, T. B. 49-21-1964.)

68 O. D. 909, T. B. 19-21-1625.

69 O. D. 975, T. B. 28-21-1727; Oliver v. Robertson, 41 Tex. 422; McDaniel v. Harley (Tex.), 42 S. W. 323; Thayer v. Clarke, 77 S. W. 1050, affirmed 98 Tex. 142, 81 S. W. 1274; Douglas v. Douglas, 22 Idaho 336, 125 Pac. 796; Myers v. Albert, 76 Wash. 218, 135 Pac. 1003.

70 Sol. Op. 121, T. B. 39-21-1845.

71 O. D. 1110, T. B. 47-21-1933.

72 O. D. 1023, T. B. 36-21-1805.

Abatement, Credit and Refund in Case of Community Income. The following procedure has been approved with regard to amended returns and claims for refund, credit, or abatement under the ruling contained in the preceding paragraph with regard to community income under the laws of Texas, in so far as taxpayers in the state of Texas are concerned: Amended separate returns may be filed for each of the taxing years in which the law of Texas contains a provision giving husband and wife equal rights to community property, subject to the five-year statute of limitations. A claim for credit of the net amount of taxes overpaid for any of the taxable years may be filed for the amount of assessment outstanding and claim for refund filed for the balance. A claim for abatement instead of a claim for credit, however, should be filed for excessive tax assessed for 1919 over the tax due for 1919 under amended separate returns. A claim for refund may be filed for the entire net overpayment if no assessment is outstanding.[73] Where such claims for the refund of taxes erroneously paid for 1919 and prior years have been filed they may be converted into claims for credit to be applied against any taxes due from the husband or wife, as shown by separate returns filed by them for the taxable year 1920 and subsequent years, subject to the provision of § 252 of the Revenue Act of 1918.[74] The adjustment of taxes between husband and wife due on amended separate returns will be made as a matter of accounting and no claim for credit should be filed. Any claim for abatement, refund or credit must be accompanied by an agreement signed by husband and wife, consenting to adjustments therein demanded.[75] In all cases in which it appears that amended separate returns are filed and the income shown in the returns now filed was disclosed in a prior return or returns no penalty on account of delinquency will be asserted and interest on account of failure to pay the tax shown by the returns on the date payment was required by law will not be assessed. Where a claim for credit is filed, bond will not be required.[76] A husband and wife domiciled in Texas January 1, 1918, and who abandoned that domicile August, 1919, the husband having included in his 1918 and 1919 income tax returns income received from all sources, including personal earnings, and no returns having been filed by the wife, may file amended separate returns for

[73] O. D. 757, T. B. 51-20-1358.
[74] O. D. 854, T. B. 12-21-1525.
[75] O. D. 1068, T. B. 42-21-1873.
[76] O. D. 757, T. B. 51-20-1358.

1918, each reporting as gross income one-half the income received during that year which constituted "community" income. They may also file amended separate returns for 1919, each reporting as gross income one-half the income received prior to the abandonment of the marital domicile in Texas, which constituted "community" income.[77] In the case of a deceased taxpayer, the proper person to file the amended return or claim is the executor or administrator. Where the estate has been placed in the hands of trustees, the amended return or claim is acceptable only when filed by the trustees. Where the administrator or executor has been discharged or there has been no administration upon the estate an amended return and claim should be filed by a duly authorized representative of all the individuals claiming any portion of the property of the deceased. In all cases involving the filing of a separate amended return and claim for a deceased taxpayer, an agreement, signed by the surviving spouse and the duly authorized agent or representative of the deceased taxpayer, consenting to the adjustments therein demanded, must accompany such return and claim.[78]

Minors.[79] Minors are required to make returns unless their income is included in the return of the parent or reported by a fiduciary.[80]

Incompetents. Incompetents or insane persons are unable to make their own returns, and their returns must be made by the guardian or other person charged with the care of the person or property of such incompetent or insane person.[81]

Agents. The return of a taxpayer may be made by an agent when by reason of illness, absence, or nonresidence the person liable for the return is unable to make it, the agent assuming the responsibility for making the return and incurring liability to the specific penalties provided for erroneous, false, or fraudu-

77 O. D. 810, T. B. 7-21-1451.

78 O. D. 920, T. B. 20-21-1643.

79 A minor is a person under 21 years of age or under the statutory age of majority where he or she lives (Reg. 45, Art. 403). The statutory ages of majority in the different states are set forth in Chapter 34.

80 Revenue Act of 1921, § 223; Revenue Act of 1918, § 223; Reg. 45, Art. 403. Under the 1916 and 1917 Laws, minors were not required to make returns, such returns being made by their guardians (Reg. 33, Rev., Art. 17; letter from treasury department dated April 11, 1918; I. T. S. 1918, ¶ 3295). The change to the present rule was accomplished by the omission of the words "of lawful age" from the section requiring returns of individuals. Compare Revenue Act of 1916, § 8 (b) with Revenue Act of 1918, § 223.

81 Revenue Act of 1921, § 223; Revenue Act of 1918, § 223; Reg. 45, Art. 422.

lent returns.[82] Responsible representatives of nonresident aliens having charge of the property of nonresident aliens may be charged with the duty of making a return and paying the tax normal and additional, on the income passing through their hands.[83]

Fiduciaries. Guardians, trustees, executors, administrators, receivers, conservators or any persons acting in a fiduciary capacity are charged with special duties under the law. These duties are fully discussed in another chapter.[84]

Persons Dying During the Year. When a person dies during any calendar year, it is the duty of the executor or administrator or person taking charge of his property to make a return for the deceased from the beginning of the year to the date of death.[85] If the decedent was a citizen or resident and died after the close of the calendar year, but before March 15 of the following year, and has not made a return for the preceding calendar year, a return should be made for the full year preceding and in addition a return from January 1 of the current year to the date of death. If during the period in which the decedent lived he was not in receipt of $1,000 of net income, if unmarried, or $2,500 if married or the head of a family, no return need be filed,[86] unless he was a nonresident alien, in which case a return should be filed, whether he was married or single, regardless of amount.[87] The fact that a person may have died before the passage of the law does not relieve his estate from liability to tax, if he lived after the incidence of the tax.[88]

[82] Revenue Act of 1921, § 223; Revenue Act of 1918, § 223.

[83] Revenue Act of 1921, § 223; Revenue Act of 1918, § 223; Reg. 45, Art. 404. See Chapter 5.

[84] Revenue Act of 1921, § 225; Revenue Act of 1918, § 225. See Chapter 6.

[85] Reg. 45, Art. 421; Mandell v. Pierce, 3 Cliff. 134, 16 Fed. Cas. No. 9008.

[86] Reg. 45, Art. 421.

[87] Reg. 33, Rev., Arts. 4 and 14; Reg. 45, Art. 403. Nonresident aliens reporting on the calendar year basis are not obliged to file returns until June 15.

[88] Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654. Thus, a person dying after January 1, 1919, but before February 25, 1919, the date on which the 1918 Law went into effect, will be held to be taxable thereunder. The effect of making the act retroactive is to apply it to him exactly as if it had been enacted on January 1, 1918.

CHAPTER 4

NONRESIDENT ALIENS

The law imposes a tax upon the net income received by nonresident alien individuals "from sources within the United States."[1] The Revenue Act of 1921 contains many new provisions dealing with the taxation of nonresident aliens, but in general these provisions do not change the basic scheme for the taxation of this class of taxpayers. In large part the new provisions, as will be seen in the following paragraphs, are an amplification of definition of the troublesome term "sources within the United States," an expression which had received a more detailed definition in the 1918 Law than ever before. Some of the provisions defining this term are a statutory enactment of previous departmental regulations.

Who Is a Nonresident Alien.[2] The definition of the term "nonresident alien" would seem to remain the same under the Revenue Act of 1921 as it was under the 1918 Law, with an exception indicated below. Therefore the regulations issued under that law are generally applicable under the present statute. Ordinarily it is a simple matter to determine whether an individual is or is not a nonresident alien; he falls into this class if he is neither a citizen nor a resident. Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of United States) and who is not a resident of the United States is subject to income tax upon income derived from sources within the United States, and his tax is computed and paid in the same manner and subject to the same conditions as the tax of nonresident aliens who are citizens or subjects of foreign countries.[3] The term "nonresident alien," therefore, is used in this chapter to include any nonresident citizen of any possession of the United States. Difficulty may arise in determining whether an individual is or is not a nonresident

[1] Revenue Act of 1921, § 213 (c).

[2] The term "nonresident aliens," as used in several places in the 1916 Law, was not defined therein, but clearly referred to individuals only and not to partnerships, corporations, or associations. The Revenue Act of 1918, however, removed all doubt by using the expression "nonresident alien *individuals*," and the Revenue Act of 1921 uses the same expression (Revenue Act of 1921, §§ 213 (c), 216 (e); Revenue Act of 1918, § 213 (c); Reg. 45, Art. 3).

[3] Revenue Act of 1921, § 260; Revenue Act of 1918, § 260.

alien, where a nonresident citizen, naturalized or native, has resided abroad for a period sufficient to raise a presumption that he has abandoned his citizenship,[4] and again where an alien has resided in this country for a period so long as to raise a presumption of residence. In either of these cases the intent of the individual is important. The treasury department holds that the status of a nonresident native or naturalized citizen remains unchanged until some affirmative action is taken, or the right to citizenship is forfeited by some overt act.[5] When any naturalized citizen has left the United States and resided for two years in the foreign country from which he came, or for five years in any other foreign country, he is presumed to have lost his American citizenship; but this presumption does not apply to residence abroad while the United States is at war. An Italian, who has come to the United States and filed his declaration of intention to become a citizen, but who has not yet received his final citizenship papers, is an alien. A Swede, who, after having come to the United States and become naturalized here, returned to Sweden and resided there for two years prior to April 6, 1917, is presumed to be once more an alien.[6] On the other hand, an alien, coming to the United States with the intention of becoming a resident within the meaning and intent of the income tax statute, may indicate that fact and thereupon will be taxed as a resident, regardless of the length of time he has been here.[7] The tests as to the residence of aliens located within this country have been set forth in another chapter.[8]

[4] The Act of March 2, 1907, provides, briefly, that any American citizen becomes an alien by becoming naturalized in a foreign state or taking an oath of allegiance to any foreign state. A naturalized citizen residing for two years in the country from which he came or for five years in any other foreign country, is presumed to have renounced his American citizenship in the absence of satisfactory evidence to the contrary. A woman assumes the nationality of her husband, but may resume her original citizenship on becoming a widow; she assumes or retains her American citizenship as a widow if, living abroad, she registers with a United States consul, or without formal action if she resides here. Minor children of naturalized citizens are deemed to be citizens from the time they begin to reside permanently in this country. Children born outside of the United States of citizens, and continuing to reside abroad must at the age of 18 declare their intention as to citizenship. Determination of citizenship by the state department under this act is not conclusive upon the treasury department; other factors may also be considered, as indicated in the text. See also O. D. 533, T. B. 23-20-983 as to resumption of citizenship by widow of nonresident alien.

[5] T. D. 2135.

[6] Reg. 45, Art. 4.

[7] Reg. 45, Art. 313; T. D. 2242. See Chapter 3 for status of resident aliens.

[8] See Chapter 3.

The status of an alien leaving the United States during the taxable year is determined by his status on the last day of his taxable period. If the alien had formed no intention of leaving the United States he will be taxed as a resident alien. If his intention to depart was formed prior to the departure, he will be taxed as a nonresident alien for such period. In either case the alien is entitled to the full exemption to which he would have been entitled if his return had been filed for the full taxable year. If the absence of a resident alien is to be only temporary, he will not lose his status as resident by reason of such absence.[9] An alien who established a residence in the United States in 1910 and subsequently acquired property interests in this country and who enlisted in the army of his native country in 1917, serving abroad until 1919, when he returned to the United States in accordance with an intention to do so expressed prior to his departure, will not be considered to have lost his status of resident alien and will be required to render returns as such, including in gross income the compensation received for services in the foreign army as well as his taxable income from all other sources.[10] A nonresident alien who has served in the United States army for a period of one year is considered a resident for income tax purposes.[11] The members of families of foreign ambassadors and ministers are considered nonresident aliens.[12]

Residence of Alien Seamen. In order to determine whether an alien seaman is a resident, it is necessary to decide whether the presumption of nonresidence is overcome by facts showing that he has established a residence in the territorial United States, which consists of the states, the District of Columbia, and the territories of Hawaii and Alaska, and excludes other places. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel flying the United States flag and engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the territorial United States, although the nature of his calling requires him to be absent from the place where his

[9] O. D. 468, T. B. 16-20-867.

[10] O. D. 498, T. B. 19-20-921.

[11] O. D. 117, T. B. 3-19-175.

[12] O. D. 198, T. B. 9-19-343.

residence is established for a long period. An alien seaman may acquire such a residence at a sailor's boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is *bona fide*. The filing of Form 1078 (Revised), or taking out first citizenship papers, is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient. The fact that a head tax has been paid on behalf of an alien seaman entering the United States is no evidence that he has acquired residence, because the head tax is payable unless the alien who is entering the country is merely in transit through the country. An alien may remain a nonresident although he is not in transit through the country.[13] It has been held that vessels plying between the continental United States and Porto Rico are engaged in "foreign trade." A citizen and resident of Porto Rico employed as seaman aboard such a vessel and who has not established himself otherwise as a resident of the United States occupies the status of a nonresident alien.[14] The term "foreign trade" includes the transportation upon the high seas of passengers and freight between the United States and foreign countries.[15]

Citizens Who Are Treated As Nonresident Aliens. The Revenue Act of 1921 contains a new provision giving a certain class of United States citizens the privilege of being treated as nonresident aliens and being taxable only upon gross income "from sources within the United States." In order to be entitled to this privilege a citizen of the United States must satisfy the following conditions: (1) 80% or more of his gross income (computed with the benefit of being treated as a nonresident alien) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) must be derived from sources within a possession of the United States; and (2) 50% or more of his gross income (computed without the benefit of being treated as a nonresident alien) for the same three-year period or the applicable part thereof, must be derived from the active conduct of a trade or business within a possession of the United States, either on his own account or as an employee or agent of another. The gross income of such citizen, however, includes any amounts received within the

[13] Reg. 45, Art. 312a; T. D. 2869. As to when the wages of alien seamen are subject to tax, see Reg. 45, Art. 92a and p. 67.

[14] O. D. 536, T. B. 23-20-987.

[15] O. D. 315, T. B. 26-19-591.

United States, whether derived from sources within or without the United States.[16] The term "nonresident alien" or "nonresident alien individual" as used in this chapter includes citizens of the United States, as thus defined. The term "foreign corporation" includes domestic corporations entitled under this provision of the statute to classification as a foreign corporation and subject only to tax upon gross income from sources within the United States, when they fulfill the same conditions which have been detailed above in respect to United States citizens.

Rate of Tax. The rate of normal tax upon nonresident aliens is the same as in the case of citizens and residents (8%), but nonresident aliens do not secure the benefit of the lower rate (4%) on the first $4,000 of income. The surtax rates upon nonresident aliens are the same as the rates upon citizens and residents.[17]

Extent to Which Nonresident Aliens are Taxable. Nonresident aliens are subject to the normal tax and the surtax imposed by the Revenue Act of 1921, upon their net income received from all "sources within the United States." The Revenue Act of 1918 also subjected nonresident aliens to tax on income from such "sources." The chief difference between the two statutes lies in the definition adopted for this term. The definition contained in the present law is much more ample and detailed, and, in one or two respects, different. Little progress has been made in determining the taxes of nonresident aliens under the 1918 Law, and for that reason it seems advisable to consider in this chapter not only the present law, but the provisions in force with regard to nonresident aliens for the last few years. It may be noted in passing that, irrespective of any rules of statutory construction, the present law no doubt to a considerable extent expresses the intention of congress in the vaguer and less detailed statutes which preceded it, the greater definiteness of the present law being founded upon the experience of the treasury department in administering those previous laws. Notwithstanding the increased precision of the Revenue Act of 1921, the difficult problem of taxing nonresident aliens justly and upon a basis consistent with economics and reason is by no means solved. The difficulty of the problem is inherent and can only be finally solved in each case which arises by the fairest possible application of the rules set forth in the statute and a

16 Revenue Act of 1921, § 262. The term "possession of the United States", as used in the text above, does not include the Virgin Islands.

17 Revenue Act of 1921, §§ 210, 211.

certain disregard of technicalities and forms, in favor of substantial considerations. Inasmuch as the present law, like the 1918 Law, taxes foreign corporations in the same manner as nonresident alien individuals on income "from sources within the United States"[18] the convenience of the reader will probably be furthered by a consideration of that term in one place, as it applies to both nonresident aliens and foreign corporations. This has been done, except that any rulings having sole bearing upon foreign corporations are reserved for a later chapter.[19]

Income From Sources Within the United States. The Revenue Act of 1918 defined income from sources within the United States as including "interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States."[20]

[18] Revenue Act of 1921, § 234 (b).

[19] See Chapter 12.

[20] Revenue Act of 1918, § 213 (c); Reg. 45, Art. 3, T. D. 2876. The 1913 Law imposed a tax in the net income of nonresident aliens "from all property owned and from every business, trade, or profession carried on in the United States." This language was held, under two opinions of the attorney-general, not to include interest or dividends received by nonresident alien investors from domestic corporations, but on March 21, 1916, the treasury department reversed this holding and thereafter claimed the tax from nonresident aliens on these classes of income. (T. D. 2313.) In De Ganay v. Lederer, 239 Fed. 568, the district court held a nonresident alien taxable on such income if the stock certificates and bonds were kept in this country, as then they acquired a situs here for purposes of the income tax. This decision has now been affirmed by the United States Supreme Court (250 U. S. 376), which takes the position that stock certificates, bonds, and mortgages are "property" within the meaning of the statute, having a situs within the United States in spite of the maxim *mobilia sequuntur personam*. The court said: "In the case under consideration the stocks and bonds were those of corporations organized under the laws of the United States, and the bonds and mortgages were secured upon property in Pennsylvania. The certificates of stock, the bonds and mortgages were in the Pennsylvania Company's offices in Philadelphia. Not only is this so, but the stocks, bonds and mortgages were held under a power of attorney which gave authority to the agent to sell, assign, or transfer any of them, and to invest and reinvest the proceeds of such sales as it might deem best in the management of the business and affairs of the principal. It is difficult to conceive how property could be more completely localized in the United States. There can be no question of the power of Congress to tax the income from such securities. Thus situated and held, and with the authority given to the local agent over them, we think the income derived is clearly from property within the United States within the meaning of Congress as expressed in the

Following the statutory definition the most comprehensive ruling issued under the 1918 Law defining gross income from sources within the United States includes in the term, in addition to the items specified in the statutes, rentals, and royalties from property, and income from business carried on in the United States, interest on deposits in banks located within the United States, income from capital otherwise invested in the United States, and income from services rendered or labor performed within the United States.[21]

The language just quoted and the regulations adopted in pursuance thereof are evidently an attempt to tax income arising from "sources within the United States," rather than the right of doing any thing or enjoying any privilege in the United States.[22] It will be noted that the 1916 Law was the first law using the expression "sources within the United States,"[23] the 1913 Law having used the phrase "business transacted and capi-

statute under consideration." The language of the 1916 Law and the present law expressly included such income, regardless of where the securities might be kept.

[21] Reg. 45, Art. 91. In the earliest edition of Regulations 45 income from isolated transactions or activities directly resulting in gain, carried on within the United States by a nonresident or his representative in person, was stated to be from sources within the United States, but the treasury department later apparently abandoned this position.

[22] This conclusion is supported by a consideration of the historical circumstances under which the acts of 1909, 1913 and 1916 and 1918 were passed. The act of August 5, 1909, which has been held to be an *excise* tax law, imposing a tax measured by net income, was necessarily so, because the constitutional authority of Congress "to lay and collect taxes on *incomes* from whatever source derived, without apportionment" was first granted by the Sixteenth Amendment to the Constitution, which was adopted in 1913, and the constitutionality of the 1913 Law has been sustained *as an income tax* on the basis of this constitutional amendment (Brushhaber v. Union Pacific R. R. Co., 240 U. S. 1). The Sixteenth Amendment was adopted plainly with the view of relieving *income* taxes from apportionment and the Revenue Act of 1916, and the Revenue Act of 1918, as well as the act of October 3, 1913, were passed as *income* taxes in consequence of the relief granted by the Sixteenth Amendment. Furthermore (as to foreign corporations) the socalled capital stock tax, imposed by the Revenue Act of 1918, (§ 1000 et seq.) and the Revenue Act of 1921 (§ 1000 et seq.) are excise taxes for the privilege of doing business and it is self-evident that Congress did not intend to impose two taxes for the same privilege.

[23] This law provided that nonresident aliens should be taxed upon income "from sources within the United States * * * including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise" (Revenue Act of 1916, § 1 (a)); and that the income tax should be "levied, assessed, collected and paid annually upon the total net in-

tal invested within the United States."[24] The word "source" conveys only one idea—that of origin.[25] It is defined in the Standard Dictionary as follows: "That from which any act, movement, or effect proceeds; a person or thing that originates, sets in motion, or is a primary agency in producing any course of action or result; an originator; creator; origin. A place where something is found or whence it is taken or derived." This is its natural, ordinary, and familiar meaning, and it is particularly true that terms used in statutes describing objects of taxation should be construed according to their popular signification.[26] The "source" should not be restricted to the place where payment is made, since such place may be arbitrarily selected without relation to the nature of the transaction and is not indicative of source.[27] The same considerations apply to the place where title passes under a contract of sale. The intention of Congress seems to have been to discard the 1913 basis of taxing nonresident aliens and foreign corporations on income accruing from "business transacted and capital invested" in the United States (as well as the 1909 excise basis) and to tax these classes of taxpayers on income arising from "sources within the United States." The object of this phrase may well be, on the one hand, to prevent nonresident aliens and foreign corporations from deriving income from the United States free from tax by virtue of a technical construction of the phrase "business transacted and capital invested"[28] and, on the other hand, to prevent the undue

come received in the preceding calendar year from all *sources within the United States* by every corporation, joint-stock company or association, or insurance company, organized, authorized, or existing under the laws of any foreign country including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, and including the income derived from dividends on capital stock or from net earnings of resident corporations, joint-stock companies or associations, or insurance companies, whose net income is taxable under this title." (Revenue Act of 1916, § 10 (a).)

24 Under the 1913 Law nonresident aliens and foreign corporations were taxable only upon the "net income accruing from business transacted and capital invested within the United States." The similarity between the 1913 Law and the British law taxing nonresident foreign corporations on gains arising or accruing from "any trade as exercised within the United Kingdom" should be noted.

25 The word "source" has been defined by regulation to mean "the place of origin of income." (Reg. 33, Art. 66.)

26 De Ganay v. Lederer, 250 U. S. 376, decided June 9, 1919. See Chapter 47 for other cases on this point.

27 O. D. 651, T. B. 35-20-1174.

28 See attorney-general's opinions under date of October 23, 1913, and July 15, 1914, as to taxability of interest on bonds and dividends on stock

imposition of a tax when the real source of income is not within this country. The Revenue Act of 1918 goes further than the 1916 Law in expressly citing certain kinds of income[29] as being from "sources within the United States" and together with the 1916 Law marks a long step in advance towards international comity in taxation[30]—a sincere regard for the essentially just and proper jurisdictional limitation upon the exercise of the sovereign power and an avoidance of taking constructive jurisdiction for the purpose of taxing income which rightly should not be levied upon to defray the burdens of government in the United States.

With this statutory and departmental definition of the term "sources within the United States" in mind, and in the light of the general principles which have just been discussed, it seems best to consider the term as defined by the present law separately in respect of the several classes of income referred to in the statute.

Income From Interest. The Revenue Act of 1921 provides[31] that the following shall constitute income from "sources within the United States," and that all other interest shall be regarded as from "sources without the United States":

"Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including (a) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or (b) interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor, or for such part of such period

under the language of the Act of October 3, 1913, with respect to nonresident aliens, as one of the reasons for adopting the phrase "sources within the United States."

[29] Cf. Revenue Act of 1918, § 233 (b), and Revenue Act of 1916, § 10 (a).

[30] The evil of double taxation as between the states of this country was deprecated by Mr. Justice Holmes in Kidd v. Alabama, 188 U. S. 730, at p. 732, where he said: "No doubt it would be a great advantage to the country and to the individual states if principles of taxation could be agreed upon which did not conflict with each other, and a common scheme could be adopted by which taxation of substantially the same property in two jurisdictions could be avoided."

[31] Revenue Act of 1921, § 217 (a) 1, (c) 1.

immediately preceding the close of such taxable year as may be applicable."

This provision is a repetition of the Revenue Act of 1918, except that the interest specified under (a) and (b) is excluded from gross income from "sources within the United States."[32] The interest specified under (a) was taxable under the 1918 Law.[33] It was also ruled under that law that where a bank in the United States collects interest upon foreign securities for its nonresident alien customers and credits same to their account, allowing interest on the balance so maintained, the identity of the interest derived from foreign securities is lost so that the interest thus paid or credited was subject to tax and withholding.[34] Where nonresident aliens purchase British Government treasury bills at a discount in United States markets and collect the same at maturity either in the foreign country or from the paying agent of that government in the United States, such discount is not income from sources within the United States.[35]

The place where interest is payable is immaterial; the test is whether or not it is paid on bonds, notes, or other interest-bearing obligations of *residents*, corporate, or otherwise.[36] Interest upon obligations of corporations organized in the United States, but doing no business and owning no property therein, is not taxable when paid to nonresident aliens.[37] Where bonds, notes or other obligations of a foreign government are underwritten by a United States banking establishment and are by their terms payable at an office of such banking establishment in the United States, interest paid from the United States office to nonresident alien individuals or foreign corporations who are holders of such securities is not regarded as income from "sources within the United States."[38] A domestic firm opened a credit with a foreign bank which was to be used by drafts which the foreign bank agreed to accept. Various acceptances and renewals were effected during a certain period, the last accepted draft having come due in 1914. The domestic firm settled most of its debt in London with a correspondent of the bank, and at the end of 1919, the balance, representing part of the interest

[32] Cf. Revenue Act of 1921, § 217 (a) 1; Revenue Act of 1918, § 213 (b).

[33] Reg. 45, Art. 91.

[34] O. D. 269, T. B. 18-19-485.

[35] O. D. 534, T. B. 23-20-985.

[36] O. D. 35, T. B. 1-19-47; O. D. 239, T. B. 13-19-417; O. D. 651, T. B. 35-20-1174.

[37] Reg. 45, Art. 92; O. D. 908, T. B. 18-19-478.

[38] O. D. 786, T. B. 1-19-16.

and commissions, was paid in the foreign country in foreign money. It was held under the 1918 Law that the obligation of the domestic firm to pay the drafts which were accepted by the foreign bank, and the interest thereon, is such an "interest-bearing obligation" as is contemplated by the statute, regardless of the fact that the debt was incurred outside the jurisdiction of the United States and the interest was paid in a foreign country in foreign money. The commissions were paid for services rendered by a nonresident foreign corporation in a foreign country and were not income from a source within the United States, but the amount paid as interest was subject to tax.[39]

INTEREST UPON OBLIGATIONS OF THE UNITED STATES. Interest received on and after March 3, 1919, on bonds, notes and certificates of indebtedness of the United States, and bonds of the War Finance Corporation, while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership or association, not engaged in business in the United States is exempt from all income and war-profits and excess-profits taxes.[40] Where trustees hold United States Liberty bonds or Victory notes in trust for a nonresident alien life beneficiary and are to distribute the income periodically, the bonds and notes are held to be "beneficially owned" by such nonresident alien.[41]

Income From Dividends. The Revenue Act of 1921 provides[42] that the following shall constitute income from "sources within the United States" and that all other dividends shall be regarded as from "sources without the United States":

"The amount received as dividends (a) from a domestic corporation other than a corporation entitled to the benefits of Section 262, or (b) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section."

The Revenue Act of 1918 provided that gross income "from sources within the United States" included dividends from "res-

[39] O. D. 1062, T. B. 41-21-1863.

[40] Reg. 45, Art. 93; Act of July 9, 1918 (Public No. 192), § 3, as amended by Act of March 3, 1919, § 4. This is true notwithstanding the provisions of the Second Liberty Bond Act (Act of September 24, 1917, Public No. 43), the Third Liberty Bond Act (Act of April 4, 1918, Public No. 120), and the War Finance Corporation Act (Act of April 5, 1918, Public No. 121).

[41] O. D. 464, T. B. 16-20-861.

[42] Revenue Act of 1921, § 217 (a) 2, (c) 2.

ident" corporations, but permitted a credit for purposes of the normal tax (in the case of nonresident alien individuals) and the deduction (in the case of foreign corporations) of dividends from a corporation taxable upon its net income, or from a personal service corporation out of earnings or profits upon which income tax had been imposed.[43] If a foreign payor corporation paid any tax upon its income, however small that tax (or the income from United States sources upon which it was paid) might be, its dividends might be so credited or deducted by nonresident alien individuals and foreign corporations respectively.[44] The exemption of dividends from the normal tax applied not only to dividends received direct from a corporation, but also to dividends received through the medium of fiduciaries or partnerships.[45] Dividends of nonresident foreign corporations (that is, corporations not engaged in trade or business within the United States and not having any office or place of business in this country) were not taxable in the hands of a nonresident alien, even though such dividends were payable in this country.[46] Dividends on stock of corporations organized in the United States, but doing no business in the United States and owning no property therein, were held not to be taxable when paid to nonresident aliens.[47]

[43] See Revenue Act of 1918, §§ 213 (c), 216 (a), 233 (c), 234 (a) 6, (b).

[44] Letter from treasury department dated June 9, 1919; I. T. S. 1921, ¶ 1661.

[45] See Chapter 19 for a further discussion of this subject.

[46] Revenue Act of 1918, § 213 (c). See also T. D. 2012, T. D. 2030, T. D. 2313, T. D. 2325. Letter from treasury department dated April 5, 1916, I. T. S. 1919, ¶ 687. In two provisions of the 1916 Law (Revenue Act of 1916, §§ 1 (b) and 8 (b)) nonresident aliens were excepted from the requirements of making reports on and paying the surtax on "such income (income derived from dividends on the capital stock or from the net earnings of any corporation) derived from sources without the United States." Although this language was not construed by the courts or by any regulation, it undoubtedly applied to dividends received from foreign corporations where the earnings of such foreign corporations were derived from sources without the United States even though the dividends were payable in this country, and there seems to be ground for the contention that it also applied with equal force whether the corporation was foreign or domestic. Under the 1918 Law it is provided (Revenue Act of 1918, § 213 (c)), that in the case of nonresident aliens "gross income includes only the gross income from sources within the United States, including * * * and including dividends from *resident* corporations." It may, therefore, be said that this language removes the doubt existing under the provisions of the 1916 Law, and places the taxability of nonresident aliens in respect to dividends on the ground of the residence of the corporation paying the dividends.

[47] Reg. 45, Art. 92. The English law taxes an English company which

Under the Revenue Act of 1921, while dividends from domestic corporations (except those taxed as foreign corporations)[48] are to be included in gross income by nonresident alien individuals and foreign corporations, they may be credited for purposes of the normal tax by nonresident alien individuals, and deducted in ascertaining net income by foreign corporations.[49] This makes them subject to the surtaxes in the case of individuals, but would seem to free them from tax in the case of foreign corporations. The same considerations would seem to apply to dividends from foreign corporations with a gross income, for the three-year period preceding the close of the taxable year preceding the date of declaration, of 50% or more from sources within the United States. Since dividends from foreign corporations with a gross income, as indicated above, of less than 50% from sources within the United States are income from sources without the United States, all dividends would seem to be free from tax under the present law, in the case of a foreign corporation.

Income From Personal Services. The Revenue Act of 1921 provides[50] that "compensation for labor or personal services performed in the United States" shall constitute income from "sources *within* the United States," and that "compensation for labor or personal service performed *without* the United States" shall constitute income "from sources without the United States." This provision is a statutory enactment of departmental regulations under the 1918 Law.[51] A nonresident alien individual employed by a domestic corporation on a monthly salary basis as its salesman in a foreign territory, who visits the home office of the company the first part of each year for the purpose of reporting on sales and conditions generally in the foreign markets and receiving instructions in sales methods and in regard to new apparatus, is not subject to tax on the salary he receives while in the United States.[52]

has permanently located its business and seat of management abroad only with respect to the profits of the English shareholders.

48 See Revenue Act of 1921, § 262.

49 See Revenue Act of 1921, §§ 213 (c), 216 (a), 217, 233 (b), 234 (a), 6, (b).

50 Revenue Act of 1921, § 217 (a) 3, (c) 3.

51 Reg. 45, Art. 92. Under the 1913 Law it was held that compensation paid to nonresident aliens for services rendered in a foreign country, including business and traveling expenses, was not taxable. (T. D. 2152.) The 1916 Law by imposing a tax on "income from all sources within the United States" raised a question as to the taxability of such compensation. (Reg. 33, Rev., Art. 32.)

52 O. D. 578, T. B. 28-20-1053. Compensation received by nonresident alien munitions inspectors and purchasing agents, from foreign governments is not subject to tax. (Reg. 45, Art. 92.)

WAGES OF ALIEN SEAMEN. While resident alien seamen are taxable like citizens on their entire income from whatever sources derived, nonresident alien seamen are taxable only on income from sources within the United States. Ordinarily, wages received for services rendered inside the territorial United States are to be regarded as from sources within the United States. The wages of an alien seaman earned on a coastwise vessel are from sources within the United States, but wages earned by an alien seaman on a ship regularly engaged in foreign trade are not to be regarded as from sources within the United States, even though the ship flies the American flag, or although during a part of the time the ship touched at United States ports and remained there a reasonable time for the transaction of its business. The presence of a seaman aboard a ship which enters a port for such purposes of foreign trade is merely transitory and wages earned during that period by a nonresident alien seaman are not taxable.[53] The wages earned by persons serving aboard vessels plying between the continental United States and Porto Rico do not constitute income from sources within the United States since such vessels are held to be engaged in foreign trade.[54] A steamer engaged in foreign trade which lies for a period of two weeks in a United States port for the purpose of completing repairs is deemed to be in such port a reasonable time for the transaction of business, and wages paid to its nonresident seamen during such period are income from sources without the United States.[55] Wages earned by a nonresident alien on an occasional coastwise voyage on a vessel generally making foreign voyages are income from sources within the United States.[56]

A vessel sailing from a port in the United States on the Pacific coast to a port in the United States on the Atlantic coast, or vice versa, via the Panama Canal, does not come within the meaning of the term "a vessel engaged in foreign trade." The wages of nonresident alien seamen received for services rendered on such vessels are subject to withholding.[57] There is no withholding from the wages of alien seamen unless they are nonresidents.[58] An employer is, however, required to render a re-

[53] Reg. 45, Art. 92a. As to the status of alien seamen as residents or nonresidents, see Reg. 45, Art. 312a.

[54] O. D. 536, T. B. 23-20-987.

[55] O. D. 559, T. B. 26-20-1027.

[56] O. D. 245, T. B. 13-19-424.

[57] O. D. 784, T. B. 5-21-1416.

[58] Reg. 45, Art. 92a.

turn of information in all cases where he has made payment of $1,000 or over of wages to resident alien seamen in any taxable year.[59]

Income From Rentals or Royalties. The Revenue Act of 1921 provides[60] that the following shall constitute income from "sources within the United States": "Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property;" and that the following shall constitute income from "sources without the United States": "Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property." The same rule in regard to rentals prevailed under the Revenue Act of 1918.[61] Profits derived by a nonresident alien author from the sale of all rights of serial publication to a domestic corporation of certain stories were held not to be income from "sources within the United States" under the 1918 Law, inasmuch as the author had no domicile within the United States and as the income received by him from such sale could not be said to issue out of property or business having a situs in the United States.[62]

Income From Sales and Dealings in Real Property. The Revenue Act of 1921 provides[63] that "gains, profits, and income from the sale of real property located *in* the United States" shall constitute income from "sources within the United States," and that "gains, profits, and income from the sale of real property located *without* the United States" shall constitute income from "'sources without the United States." The same rule es-

59 Letter from treasury department, dated September 30, 1919; I. T. S. 1919, ¶ 3069.

60 Revenue Act of 1921, § 217 (a) 4, (c) 4. Under the 1913 Law royalties paid to nonresident aliens under an agreement for the purchase of certain patent rights, the patents being based upon the quantity of goods produced by the use of such patents, have been held to be income accruing to nonresident aliens by reason of property owned or business carried on within the United States. (T. D. 2137). See Reg. 45, Art. 91.

61 Reg. 45, Art. 92.

62 O. D. 988, T. B. 32-21-1759.

63 Revenue Act of 1921, § 217 (a) 5, (c) 5.

tablishing the location of the property as the test of source applies to exchanges of real property.[64] The same rule prevailed under the Revenue Act of 1918.

Miscellaneous Income: Income From Manufacturing and Selling Property. It is provided[65] further in the Revenue Act of 1921 that items of gross income other than those enumerated in the preceding paragraphs "shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the commissioner with the approval of the secretary"; and also that: "Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from the country in which sold." The words "sale" or "sold" include "exchange" or "exchanged"; and the word "produced" includes "created," "fabricated," "manufactured," "extracted," "processed," "cured," or "aged."[66]

This provision should be read in the light of the following statement made by Senator Penrose in his report[67] on the Revenue Act of 1921:

"The present law is both obscure and economically unsound, inasmuch as the attorney-general has held that where goods are manufactured, or produced in the United States and sold abroad,

[64] Revenue Act of 1921, § 217 (f)

[65] Revenue Act of 1921, § 217 (e). Where a Wisconsin partnership and a New York partnership entered into a partnership agreement under which the Wisconsin partnership furnishes 40% of necessary capital and has exclusive control of purchasing, handling, storing and shipping of Wisconsin tobacco, and the New York firm furnishes 60% of the capital and has exclusive control of the sale and disposition of the tobacco, all sales being made without the state of Wisconsin, the portion of the income going to the New York firm has been held under the Wisconsin Income Tax Law to be income derived partly from property and business within the state of Wisconsin and partly from business transacted without the state, which should be allocated. (Village of Westby v. Bekkedal, 172 Wis. 114, 178 N. W. 451.)

[66] Revenue Act of 1921, § 217 (f).

[67] See report of finance committee on Internal Revenue Bill of 1921, p. 16.

no part of the profit is derived from a source within the United States."

In the opinion referred to by Senator Penrose the attorney-general dealt with the following five specific cases:

1. A corporation organized under the laws of Scotland owns and operates two sawmills in the United States. The mills saw logs into plank squares called "handle blanks" and also roughly turn hammer handles. These products are all exported to Glasgow, where they are finished at the home mill. In addition the manager of the American plant buys logs in the United States and exports them as such to Great Britain. No part of the products of the mills located in this country or of the logs purchased here is sold in the United States, but the entire output is sold in Great Britain. The plants and operations of the manager in the United States are conducted solely from funds sent to this country from the home office in Glasgow, Scotland, and no funds are sent to the home office from the American plants. No income is derived from the mere manufacture of goods; before there can be income there must be sale; and there is no income from sources within the United States from goods manufactured here unless there is, in the language of the statute,[68] "both manufacture and disposition of goods within the United States." The obvious purpose of this section is to tax only income that accrues within the United States. Congress does not attempt to tax profits arising from goods manufactured in this country but sold after being shipped abroad and without being disposed of by the owner in this country. When the corporation manufactures or partially manufactures articles in this country but does not sell or dispose of them until they are taken to Scotland, there is no income from sources within the United States. As to the purchase and exportation of logs, since profits that may accrue from such transactions are not specifically provided for in the section of the statute taxing profits on the "manufacture and disposition of goods within the United States," they are taxable, if at all, because they represent compensation from trades, businesses, commerce, etc., as enumerated in another section,[69] which are carried on within the United States. For the reasons given in cases quoted from in the footnote below[70] it is concluded that income which may accrue to the corporation in England by sale of logs purchased in the United States is not income from sources within the United States.

[68] Revenue Act of 1918, § 233 (b).

[69] Revenue Act of 1918, § 213 (a).

[70] In Sulley v. Attorney-General, 5 H. & N. 711 (2 Br. Tax Cas. 149), under a statute taxing the income of nonresidents "from any property what-

2. The second case involved an English corporation acting through a New York corporation. Under an agreement between them the latter corporation is granted the exclusive right to handle the merchandise of the former in the United States and Canada. Orders for the goods are taken by the New York corporation on net terms, payment to be made 10 days after delivery. A minimum net price for the sale of the goods by the New York corporation is fixed by the English corporation at an amount not to exceed the price obtained for similar goods in England. The New York corporation assumes credit risks and advances 50% of the minimum net price against the bills of lading or packers receipts. The amount advanced is deducted by it, together with freight charges, commissions, etc., when remitting to the English corporation the amounts collected from the customers. The New York corporation receives a 5% commission on the sale of the goods and any excess over the minimum net price, after deducting such commission, and charges for freight, duties, insurance, etc., are shared equally between the two corporations. No price that is insufficient to cover the minimum net price, plus freight, duty, and other charges, is accepted without the approval

ever in the United Kingdom, or profession, trade, employment, or vocation exercised within the United Kingdom," the facts are similar to those above stated. Sulley was a partner in a firm of general merchants and drapers carrying on business in both the United States and England. Sulley resided in England and the other petitioners in the United States. Sulley transacted the business of the firm in England, which consisted of purchasing goods in England and shipping them to the United States. No money was received in England except what was sent from the United States, and the profits of the business were made by the resale of goods at an increased price in the United States. The court held that the liability to income tax attached only to such profits as came home to England as the share of Sulley, the partner resident there. The Lord Chief Justice said:

"The question is, whether there is a carrying on or exercise of the trade in this country. I think there is not, looking at the sense in which the term is used and having regard to the subject-matter of the statute. Wherever a merchant is established, in the course of his operations his dealings must extend over various places; he buys in one place and sells in another. But he has one principal place in which he may be said to trade, viz., where his profits come home to him. That is where he exercises his trade. It would be very inconvenient if this were otherwise. If a man were liable to income tax in every country in which his agents are established, it would lead to great injustice. The argument for the Crown must be carried to this extent, that merely buying goods in this country is a trade exercised here so as to subject the purchaser of the goods to income tax. In the present case the defendant is a partner; but if the argument is well founded, this American firm might be taxed in the same way if he had been merely an agent. It would be most impolitic thus to tax those who come here as customers. The subject of a foreign state, not resident here, can not be

of the English corporation. The latter accepts all merchandise risks. If goods are refused or returned to the New York corporation by its customers, it is required to make every effort to dispose of them. Unless goods are sold at a profit above all expenses, the New York corporation receives no commission thereon. The goods are covered by insurance for the joint account of both corporations and are invoiced to the customer by the New York corporation. This case is the converse of the situation in 1, above. The English corporation in this case purchases goods in England and sells them within the United States, and profits accruing from such transactions are plainly profits derived from business carried on within the United States.[71] The gross income from such business is income from sources within the United States and is to be estimated in the same way that such income is estimated where both manufacture and sale are had within the United States.

3. The third case involves a partnership organized in England, consisting of two members who are citizens and residents of that country. The principal office of the firm is at Liverpool, England, but it maintains an office at Dallas, Texas, which is operated under a somewhat similar name. The Dallas office is in charge of a manager, who receives a fixed salary and a stipulated commission based upon the net earnings of the firm in accordance with a contract of employment made by him with the members of the firm. The business of the firm is that of cotton merchants and importers. The branch office is engaged in buying cotton in the United States in behalf of the firm and in shipping it to the parent office in England for disposition. It is the custom of the branch office to draw on the parent office for amounts sufficient to make such purchases, together with a liberal margin to cover estimated charges and expenses, so that at the end of the season

made amenable to our laws. How then are their profits to be made amenable to the fiscal law? Simply by the provision that whosoever carries on the business and receives the profits here shall be assessed. But in the present case no profits are received by the firm, or exist in this country. * * * The profits of the firm in America do not accrue in respect of any trade carried on in this country, but in respect to the trade carried on in New York, where the main business is conducted." In State ex rel. Manitowoc Gas Co. v. Wisconsin Tax Commission, 161 Wis. 111, 152 N. W. 848, the Supreme Court of Wisconsin said: "If an income be taxed, the recipient thereof must be domiciled within the state, or the property or business out of which the income issues must be situated within the state so that the income may be said to have a situs therein."

[71] See Werle & Co. v. Colquhoun, 2 Br. Tax Cas. 402, 58 L. T. R. 756; Turner v. Rickman, 4 Br. Tax Cas. 25; MacPherson & Co. v. Moore, 6 Br. Tax Cas. 107.

the branch office may show a balance to its credit. The branch office does not make any sales. It was held that the firm is not deriving income from sources within the United States.

4. The fourth case is that of a partnership organized in England consisting of six members, five of whom are British subjects residing in London and the other a citizen of the United States, residing in New York. The home office of the firm is in London, but it maintains a branch office in New York city in charge of and conducted under the name of the partner resident of that city. The business of the firm is that of commission merchant in raw furs. The furs are consigned to it from various parts of the world, including the United States, the sales being made almost entirely in London at auction by auctioneers employed by the firm or at private sale. The firm does not at any time take title to the goods, but title remains in the consignor until the sale, when it passes to the purchaser. The principal function of the New York office is to solicit consignments of raw furs to the firm at London, which requires the resident partner to travel to various points in the United States and Canada. The majority of goods consigned from Canada are sent to New York for shipment to London. The New York office also acts as disbursing agent for the firm in paying to consignors in the United States and Canada the proceeds of sales of their goods in London, attends to the shipment of the goods to London, and their storage and insurance in New York while waiting for steamers, and further makes advances to consignors on the security of bills of lading or express receipts. The money required to maintain the New York office is obtained by selling drafts on London, and a balance of about $20,000 is usually carried by it with a New York bank. The income of the partnership is derived from a commission of about 6% on the proceeds of sales from furs consigned to it. It collects the proceeds of the sales and deducts its commission, the expenses, if any, incurred by it for freight, insurance, or storage, and also the amount of any advances made to the consignors. The balance of the proceeds is remitted to the consignors. No profit is made on the freight or other charges. It has been held that only the income of the partner resident within the United States is taxable.

5. In the fifth case a corporation organized under the laws of Great Britain, with its home office at Manchester, England, operates a line of freight steamships between Philadelphia, Pa., and foreign ports. The corporation has no office in the United States, but consigns its steamships to a corporation at Philadelphia, who handles them as agents and brokers, together with

steamships consigned to them by other owners. The agents see to the entry and clearance of each steamer and the discharge and loading of the cargo and supplies, collect such part of the freight as is prepayable in this country for the ocean carriage, deduct the amount of the agents' disbursements and charges for their services, and remit the balance to the steamship corporation at Manchester upon the departure of the vessel. Frequently a large part of the freight is not prepayable, but is payable upon delivery of the goods at Manchester. In an opinion[72] rendered by the attorney-general under the 1909 Law it was decided that foreign steamship companies engaged in the business of transporting passengers, goods, and merchandise between ports in the United States and foreign ports, and maintaining passenger and freight agencies in this country were taxable under that act. The attorney-general said:

"* * * Their business consists entirely in transporting passengers and goods and merchandise between ports in this country and those of foreign countries, and receiving and discharging the same. Through agents located here all contracts and arrangements incident to such a business at this end of their lines are made, and all exports are delivered to their warehouses and loaded upon their vessels, and the passengers embark, while they are within the limits of the United States; and likewise here their imports are unloaded and passengers from foreign ports disembark. If these companies do not transact business in the United States they transact no business in any foreign port, and their entire business is carried on upon the high seas. To such a conclusion I am unable to give assent." A similar conclusion was arrived at in an English case[73] which held that a cable corporation established at Copenhagen, with an agent and an office in London, with cables extending between England and Denmark, was carrying on trade in England from which profit arose on account of contracts entered into with persons in England to send messages from England to other countries. Brett, L. J., said:

" * * * That which earns the profit, as I said at first, or that out of which they get the profit is the better phrase, is the money to be paid to them out of the contract, which contract is made in England, and such contracts being habitually made by them in England, it seems to me, they carry on in England the trade or business of making such contracts. Therefore, it seems to me, that these people are properly said to be persons

[72] 28 Op. Atty. Gen., dated March 9, 1910.

[73] Erichsen v. Last, 8 Q. B. D. 414; 45 L. T. 703, 4 Br. Tax Cas. 422.

from whom this duty must be collected." It was held that the English corporation derives income from sources within the United States to the extent that it derives income from freight and passenger traffic originating within the United States.[74]

The 1918 Law, upon which this opinion was based, taxed as income from "sources within the United States" all "amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States."[75] It was held under this provision that where the products of certain foreign corporations, the entire capital stock of which was owned by a domestic corporation, were sold by mail or through United States representatives visiting the foreign plants, to United States citizens and domestic corporations f. o. b. shipping point in a foreign country, no income was derived by such foreign corporations from "sources within the United States," even though invoices were made by a United States office and payments were made through the office of the domestic holding company.[76] Under the provision just quoted, it was held that the mere selling of raw materials in this country through the medium of a mail order

[74] T. D. 3111, T. B. 3-21-1401. See also A. R. M. 133, T. B. 26-21-1703.

[75] Revenue Act of 1918, §§ 213 (c), 233 (b). The use of the word "and" between "manufacture" and "disposition" was important. The word "and" is never to be construed as "or" in the absence of cogent reasons (Rice v. U. S., 53 Fed. 910). In an early edition of Regulations 45 (Reg. 45, Art. 91) the treasury department violated this rule of construction. Under the 1913 Law, under which a foreign corporation was subject to the tax on income accruing from "business transacted and capital invested" within the United States, the court held a foreign corporation taxable where (a) it sent agents into the United States to solicit purchasers for its products, hiring desk room in the United States and empowering the salesmen to make written contracts, (b) shipped its product consigned to itself in the United States to different points, where it hired storage rooms and stored the product in its own name and at its own risk to insure delivery according to contract, and to meet anticipated demands. (Laurentide Co., Ltd. v. Durey, 231 Fed. 223.) Under the 1913 Law the department held also that where a foreign corporation sent a representative to this country to solicit business, the merchandise thus sold to be shipped direct to the consignee, the corporation was transacting business in this country. The fact that the solicitor or representative had only a mailing address in this country was immaterial, as he was none the less an agent of the foreign corporation. (T. D. 2161.) An agent who was doing business in this country, buying and selling certain products of the foreign corporation, was held to be a branch of the foreign corporation, as through and by him the foreign corporation was transacting business here. (T. D. 2137.) As to the propriety of buying as a test of doing business, see Commonwealth v. Standard Oil Co., 101 Pa. St. 119.

[76] O. D. 1100, T. B. 46-21-1920.

business or unsolicited orders, did not constitute transacting business within the United States, and any income received from such transactions would not be subject to tax;[77] but that an alien who comes to the United States with merchandise which he disposes of in this country is subject to tax on the profit derived from such activities even though within the United States for a period of less than 30 days.[78] Where a foreign corporation purchased through an agent in this country bank acceptances at a certain rate of discount and sold such acceptances through that agent or some other agent, for a price greater than the price for which purchased, the amount of income received as a result of the transaction was held under the 1918 Law to represent income from "sources within the United States."[79] The purchase of bonds and sale thereof in the United States was also held to create income from "sources within the United States."[80] Where securities have been purchased in the United States for a foreign estate by a domestic company upon an order transmitted to that company by the estate, the securities then having been held by the company for safekeeping and to prevent delay in trading and sold by the company upon an order from the executors of the estate, it has been held that profits from the sale are income from sources within the United States.[81]

Broadly speaking, the commercial history of any marketable article involves two main considerations. The article is (a) manufactured—made from other products into its present state or form—and (b) disposed of. These two considerations indicate the well known distinction between a "manufacturing" and a "mercantile" business. Economically, either or both of the processes may bring a profit. The earnings of a mercantile business may be just as truly due to intelligent and well directed buying as the earnings of a manufacturing business are due to cheap and efficient manufacturing business. The profits of a manufacturing business are due to two practically indivisible factors: (1) efficient manufacturing, and (2) efficient marketing. Similarly, the profits of a mercantile business are due to two indivisible factors: (1) efficient buying, and (2) efficient selling. But Congress has seen fit to differentiate in the present law between the mercantile business and the manufacturing

[77] O. D. 294, T. B. 23-19-543.

[78] O. D. 291, T. B. 23-19-543.

[79] O. D. 221, T. B. 11-19-387.

[80] O. D. 890, T. B. 17-21-1593. But the profit on retirement of such bonds is held not to create taxable income.

[81] O. D. 863, T. B. 14-21-1546.

business. Profits from the sale of property *produced* within the United States and sold without the United States is income partly from sources within and partly from sources without the United States, but profits from the sale of property *purchased* within the United States and sold without the United States is income from sources without the United States. Conversely, profits from the sale of property *produced* without the United States and sold within the United States is income partly from sources within and partly from sources without the United States, but profits from the sale of property *purchased* without the United States and sold within the United States is income from sources within the United States. In other words, production, but not purchasing, is treated as an income factor. Selling is always such a factor.[82] Under the provision giving the commissioner broad authority and discretion to apportion to sources within and sources without the United States, it seems to be within his power to give due weight to the fact, when it obtains, that property is produced only in part in this country. When only part of the production of property takes place in the United States, the proportion of income attributable to "sources within the United States" should not be so large as it would be if complete production took place here.

Income Received From Fiduciaries. Where a nonresident alien is the beneficiary of a trust, or of the estate of a deceased person, or is the recipient of income from any property held by another, such income is taxable to the extent that it arises from sources within the United States. The intervention of an agent, trustee or other fiduciary between the nonresident alien and the source of the income does not render income subject to taxation, which otherwise would not be taxable, nor does it serve to re-

[82] See Revenue Act of 1921, § 217 (e). See also O. D. 890, T. B. 17-21-1593. This is in line with the theory of such cases as Commonwealth v. Standard Oil Co., 101 Pa. St. 119, in which the court said: "That the purchase of oil in the state by a foreign corporation for the purpose of shipping to its refineries without the state, is doing business within the state, is a proposition that does not need serious discussion. * * * Thousands of corporations and individuals in other states make their purchases of supplies of raw materials here, but it has never been seriously asserted that they were doing business within the state. It has not been the policy of the state at any time, as evidenced by its tax laws to embarrass the development and sale of her rich products, agricultural and mineral, by levying taxes upon strangers who come here to buy, and it is not the province of the courts to erect a judicial Chinese wall around the state, which could not fail to affect injuriously the best interests of the people." But the question in this case was whether the buyer transacted business in Pennsylvania, not whether it had income from sources within the state.

lieve from taxation income which otherwise would be taxed.[83] Dividends, for instance, would not be subject to the normal tax for the reason that they are paid to a trustee and by him distributed to nonresident aliens.[84] Similarly, interest upon 3¾% notes of the Fifth Liberty Loan is not made taxable by passing through the hands of a fiduciary to the beneficiary.[85]

Income From Partnerships. Nonresident aliens, who are members of partnerships deriving all their income from sources within this country, are taxable on their entire distributive shares.[86] If a partnership derives only part of its income from sources within the United States, nonresident alien partners are taxable only on that part of their respective distributive shares of the partnership profits which represent income of the partnership from such sources.[87]

Deductions Allowed in Computing Net Income. A nonresident alien is required to report all his taxable income from sources within this country, but from the gross income so reported is entitled to make certain deductions before the tax is assessed on the remainder, which constitutes his net income. The deductions are ordinarily similar in kind to those allowed to residents and citizens but, in general, are confined to expenditures connected with the production of the income subject to tax as being from sources within the United States.[88] In the case of a nonresident alien individual the deduction for *losses* incurred in any transaction entered into for profit is confined to transactions the profit of which, if they had resulted in profit, would have been taxable. The deduction for losses arising from fires, storms, shipwreck, or other casualty, or from theft, is confined to prop-

83 Letter from treasury department dated March 25, 1915; I. T. S. 1918, ¶ 110.

84 Letter from treasury department dated April 5, 1916; I. T. S. 1918, ¶¶ 32, 62, and 873.

85 Exempt income is not reported by the fiduciary as income accruing to the estate for the purpose of tax. See Revenue Act of 1921, §§ 219 (b), 212 (a) and 213; Revenue Act of 1918, §§ 219 (b), 212 (a) and 213.

86 Revenue Act of 1921, § 218; Revenue Act of 1918, § 218. See Chapters 8 and 9.

87 This is one of the many questions on which the treasury department has not as yet made any clear public statement of its position. The status of a partner differs materially from that of a stockholder in a corporation, since in the case of a partnership no separate entity is interposed between the recipient of the income and its original source. See U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27.

88 Revenue Act of 1921, § 214 (b); Revenue Act of 1918, § 214 (b).

erty within the United States.[89] The deduction for *charitable contributions* excludes gifts to foreign corporations, and includes gifts to domestic corporations, community chests, funds, or foundations created in the United States, and the Vocational Rehabilitation Fund.[90]

The other deductions (for business expenses, interest, taxes, losses in trade, bad debts, depreciation, amortization, depletion, and gains arising from a replacement of property) are allowed only if and to the extent that they are connected with income arising from sources within the United States, and the proper apportionment and allocation of the deductions with respect to sources within and without the United States is to be determined by the commissioner.[91] A "net loss," within the meaning of the 1918 Law, attributable to operations in the United States was held deductible under that law by a foreign concern.[92] An extended discussion of deductions is contained in other chapters,[93] the discussion in this chapter being limited to the provisions which apply particularly to nonresident aliens, and to some new provisions of importance contained in the Revenue Act of 1921. In general, the deductions allowed nonresident alien individuals and foreign corporations and the principles governing their computation are the same, and for the convenience of the reader, the discussion of the deductions applying to both will be found below. Some rulings having reference particularly to foreign corporations will be found in a later chapter.[94]

Apportionment of Deductions. The Revenue Act of 1921 contains some provisions[95] regarding the allocation and apportionment of deductions which are so important that they are quoted below:

"From the items of gross income * * (from sources within the United States) * * there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto

89 Cf. Revenue Act of 1921, § 234 (a) 5, 6, and Revenue Act of 1918, § 234 (a), 5, 6. Under the 1918 Law deductible losses in transactions entered into for profit had to be losses in transactions within the United States. Probably the intent of the two laws is the same.

90 Cf. Revenue Act of 1921, § 234 (a) 11; Revenue Act of 1918, § 234 (a) 11. The 1921 Law is broader in permitting the deduction of gifts to community chests, funds, or foundations created in the United States.

91 Revenue Act of 1921, § 214 (b); Revenue Act of 1918, § 214 (b). Reg. 45, Art. 271.

92 O. D. 611, T. B. 31-20-1099.

93 See Chapters 21-30.

94 See Chapter 12.

95 Revenue Act of 1921, § 217 (b), (d), (e).

and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

"From the items of gross income * * (from sources without the United States) * * there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

"Items of * * * expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the commissioner with the approval of the secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the commissioner with the approval of the secretary."

The 1918 Law did not contain any such explicit provisions regarding the allocation and apportionment of the deductions of nonresident aliens, except a provision[96] permitting the deduction by a nonresident alien (and foreign corporation) of that "proportion" of interest paid or accrued within the taxable year "which the amount of his gross income from sources within the United States bears to the amount of his gross income from all sources," and the vague provision[97] that the deductions should be allowed, in the case of a nonresident alien (and foreign corpo-

[96] Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2.

[97] Revenue Act of 1918, §§ 214 (b), 234 (b).

ration) "only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the commissioner with the approval of the secretary." Under these provisions and under the 1916 and 1913 Laws, the attempt was made to allocate deductions by processes of formulas of general apportionment in a few cases; but little progress toward any solution of this problem had been made. In one ruling a Canadian manufacturing corporation which sold part of its product in the United States and part in Canada was required to report its deductions for cost of manufacture, exclusive of interest paid on its indebtedness, in the same proportion as the quantity of its product sold in the United States bore to the total quantity sold.[98] Where under the 1916 and prior laws certain expenses, such as coal, ships, stores, etc., in the case of foreign steamship companies, could not be segregated, the total expenses of foreign corporations for such items were pro-rated in such proportion as the gross income of the corporation from sources within the United States bore to the gross income derived from all sources both within and without the United States; that is to say, if one-half of the gross income of the foreign corporation was from sources within this country, one-half of such expense was a proper deduction.[99] It was required under the 1916 Law that the deductions of a foreign corporation should as nearly as possible represent the actual expenses and authorized charges incident to the income derived from this country, and must not comprehend either directly or indirectly any expenditures or charges incurred in the transaction of business or the investment of capital without the United States.[100] A corporation deriving its sole income from this country in the form of dividends or interest on domestic stocks and bonds was permitted under the 1916 Law to deduct from the income so received such items of disbursement, loss, etc., as would be properly deductible, if the income were derived from any other source. The deduction comprehended only such expenditures, losses, etc., as were incurred in or were incidental to the creation of the income against which they were charged, and in all cases

98 Reg. 45, Art. 573.

99 T. D. 1675; Reg. 33, Art. 116. Letter from treasury department dated December 8, 1916.

100 Reg. 33, Rev., Art. 197; Reg. 33, Art. 157.

were required to be within the limits fixed by the 1916 Law.[101] The principle followed by the treasury department under the 1913 Law was that all allowable deductions should be computed upon a basis which recognized that the income arising and accruing from business done in and from this country should bear its share, and no more, of expense incident to the earning or creation of such income in the ratio that the gross income arising in and from this country bore to the entire gross income arising from business done both within and without this country.[102]

The new provisions of the 1921 Law quoted at the beginning of this paragraph represent a distinct progress from the indefinite rulings which had previously been the sole guide of the taxpayer in determining *net* (as distinguished from *gross*) income from "sources within the United States." Particularly significant is the provision that a "ratable part of any expenses, losses or other deductions which cannot be definitely allocated to some item or class of gross income" shall be deducted from gross income from "sources within the United States," and the corresponding provision for the allocation of a "ratable part" of deductions to income from "sources without the United States," and the corresponding provision for the allocation of a "ratable part" of deductions to income from "sources partly within and partly without the United States."[103] These provisions will properly allow for a just proportion of foreign overhead expense, depreciation on property without the country, and any such items which enter into the production of the income from "sources within the United States" as well as the income from other sources.

Condition to Allowance of Deductions. As a condition to obtaining the benefit of the deductions allowed by the Revenue Act of 1921, nonresident aliens are required to file a true and accurate return of total income received from all sources, corporate or otherwise, in the United States, including therein all the information which the commissioner may deem necessary for the calculation of such deductions.[104] The same requirement was contained in the Revenue Act of 1918.[105]

101 Letter from treasury department dated June 6, 1916; I. T. S. 1921, ¶ 1095.

102 Letter from treasury department dated July 18, 1916; I. T. S. 1921, ¶ 1082.

103 Revenue Act of 1921, § 217 (b), (d), (e).

104 Revenue Act of 1921, § 217 (g).

105 Revenue Act of 1918, § 217.

Credits. Nonresident aliens are permitted a credit of dividends for the purpose of the normal tax in certain cases. They are also permitted a credit for purposes of the normal tax of any interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income.[106] This subject is discussed elsewhere in this chapter.[107] A nonresident alien individual may receive the benefit of credits only by filing a true and accurate return of his total income received from all sources, corporate or otherwise, in the United States, including therein all the information which the commissioner may deem necessary for the calculation of the credits.[108]

CREDIT OF TAX WITHHELD AT THE SOURCE. As the law requires the normal tax to be withheld by the one in this country who pays fixed or determinable and annual or periodical income to a nonresident alien,[109] a due credit for the amount so withheld may be claimed by the nonresident alien in filing his return.[110] The nonresident alien should therefore keep a record of the amount of tax withheld at the source from time to time on payments made to him, and should report the aggregate sum so withheld in his return, in order that the normal tax may not be twice collected with respect to the same income.

PERSONAL EXEMPTION. Under the present law a nonresident alien is entitled to a personal exemption of only $1,000 and to no credit for dependents.[111] This credit will not be allowed unless the nonresident alien files a true and accurate return of income from all sources, but the commissioner may, in his discretion, allow the personal exemption upon the filing of a claim with a withholding agent.[112]

Returns. A nonresident alien individual must make or have made on his behalf a full and accurate return of income received

106 Revenue Act of 1921, § 216 (a), (b); Revenue Act of 1918, § 216. As to interest received after March 3, 1919, see Chapter 18.

107 See p. 64.

108 Revenue Act of 1921, § 217 (g); Revenue Act of 1918, § 217.

109 See Chapter 40.

110 Revenue Act of 1921, § 221 (d); Revenue Act of 1918, § 221 (d). Telegram from treasury department dated March 5, 1919; I. T. S. 1919, ¶ 3244.

111 Revenue Act of 1921, § 216 (e). A nonresident alien individual, similarly to a citizen or resident, was entitled, under the 1918 Law, to a personal exemption, and to a credit of $200 for each dependent, except that if he was a citizen or subject of a country which imposed an income tax the personal exemption was allowed only if his country allowed a similar credit to citizens of the United States not residing in such country. The subject of the personal exemption, both as to citizens and residents and as to nonresident aliens, is fully treated in another chapter. See Chapter 31.

112 Revenue Act of 1921, § 217 (g). See Chapter 40.

from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source.[113] A nonresident alien may have had the tax on all his income arising from sources within this country withheld at the source, although he may be taxable on a lesser amount by reason of expenses, interest, losses and other deductible items or credits. Only by filing a return may he claim these deductions and credits and secure the return to him of any amount withheld in excess of his tax liability. His return must include such information as may be deemed necessary by the commissioner for the calculation of any deductions and credits to which he may be entitled. The personal exemption may be allowed to nonresident aliens in the discretion of the commissioner without the filing of the above return of income from all sources within the United States, credit being received in such case by the filing of a claim therefor with the withholding agent.[114] The commissioner has ruled, however, that for the present the benefit of the credits allowed against net income for the purpose of the normal tax may not be received by a nonresident alien by filing a claim with the withholding agent, but only by claiming them upon filing a return of income. Unless a nonresident alien individual renders a return of income, the tax will as a general rule[115] be collected on the basis of his gross income (not his net income) from sources within the United States. Where a nonresident alien has various sources of income within the United States, so that from any one source or from all sources combined the amount of income calls for the assessment of a surtax, and a return of income is not filed by or on his behalf, the commissioner will cause a return of income to be made, and include therein the income of such nonresident alien from all sources concerning which he has information, and he will assess the tax and collect it from one or more of the sources of income within the United States of such nonresident alien, without allowance of deductions or credits, and may distrain for

[113] Revenue Act of 1921, § 223; Revenue Act of 1918, § 223; Reg. 45, Art. 403. Form 1040C was used for this purpose under the 1918 Law. For the year 1918 the same form (Form No. 1040) was prescribed for the use of all individuals, resident and nonresident. A nonresident alien made such changes as were necessary to indicate that the return covered in his case only income from sources within this country. The additional information required in order to compute the amount of deductible interest (deductions and credits under the present law) was made on a supplementary statement attached to the return.

[114] Revenue Act of 1921, § 217 (g); Revenue Act of 1918, § 217.

[115] For the exceptions to this rule see Reg. 45, Art. 316. The exceptions are discussed in Chapter 31.

the tax any property belonging to such nonresident alien.[116] For the purpose of obtaining a refund of any amount withheld in excess of his tax liability as above indicated, a nonresident alien is required to attach to his return a statement showing accurately the amounts of tax withheld, with the names and postoffice addresses of all withholding agents.[117] Upon the basis of such information the treasury department thereupon orders the withholding agent to release the excess withheld.[118]

Returns by Agents. If a nonresident alien is unable to make his own return, it may be made on his behalf by a duly authorized agent and in proper cases may also be made by guardians or other persons charged with the care of the person or property of such taxpayer.[119] It should be borne in mind that a nonresident alien may have an agent in this country for the purpose of making returns without having appointed one. The responsible representatives of nonresident aliens in connection with any sources of income which such nonresident aliens may have within the United States must make a return of such income, and must pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their nonresident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. The agent of a nonresident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes.[120] Any individual, partnership or corporation having the control, receipt, custody, disposal or payment of fixed or determinable income payable to any nonresident alien, such income with certain exceptions being required to be withheld at the source, makes a return thereof on or before March 1st of each year and pays the tax due thereon on or before June 15th.[121]

Where Filed. A nonresident alien files his return in the district in which he has his principal place of business in this country, and if he has none, then with the collector of internal revenue at Baltimore, Maryland.[122]

116 Revenue Act of 1921, § 217 (g); Reg. 45, Art. 311.

117 Reg. 45, Art. 403; T. D. 2815.

118 Telegram from treasury department dated January 25, 1917; I. T. S. 1918, ¶ 91.

119 Revenue Act of 1921, § 223; Revenue Act of 1918, § 223.

120 Reg. 45, Art. 403. See Chapter 5 for a discussion of this ruling.

121 Revenue Act of 1921, § 221; Revenue Act of 1918, § 221. See Chapters 40 and 5.

122 Revenue Act of 1921, § 227 (b); Revenue Act of 1918, § 227 (b).

WHEN FILED. The return of a nonresident alien should be filed on or before June 15th or on or before the 15th day of the sixth month following the close of such nonresident's fiscal year, accordingly as he reports for income tax purposes on the basis of the calendar or a fiscal year.[123]

EXTENSION OF TIME. Nonresident aliens are allowed a reasonable extension of time for filing returns whenever in the judgment of the commissioner good cause exists therefor.[124]

FAILURE TO FILE RETURN. In general, nonresident aliens are subject to the same penalties for failure to file returns as are citizens and residents.[125] If a return is not filed, the deductions and credits allowed by the statute cannot be claimed and the collector will collect the tax on the income of a nonresident alien and all property in the United States belonging to such nonresident alien will be liable to distraint for the tax.[126]

Paying the Tax. Except in so far as the income tax payable by a nonresident alien is collected at the source[127] the general provisions in regard to the payment of income taxes apply to nonresident aliens as well as to citizens and residents. The tax is payable in four installments, the first installment being paid at the time the return is filed; the second installment on the 15th day of the third month; the third installment on the 15th day of the sixth month; and the fourth installment on the 15th day of the ninth month, after filing the return. This subject is discussed more fully in another chapter.[128]

Abatement and Refund. If upon the filing of the return it appears that the nonresident alien is liable for less tax than the amount which has been withheld at the source, the treasury department will issue instructions to the withholding agents (whose names and addresses should be given by the nonresident alien in his return) to release at once the proper amounts.[129] After the tax has been assessed against the withholding agents by the government, abatement may be claimed, and after the tax

[123] Revenue Act of 1921, § 227 (a); Revenue Act of 1918, § 227 (a). Under the 1918 Law this date was the same as in the case of citizens and residents.

[124] Revenue Act of 1921, § 227 (a); Revenue Act of 1918, § 227 (a). See Chapter 34.

[125] See Chapter 36.

[126] Revenue Act of 1921, § 217 (g); Revenue Act of 1918, § 217.

[127] See Chapter 40.

[128] See Chapter 35.

[129] Revenue Act of 1921, § 221 (d); Revenue Act of 1918, § 221 (d); Reg. 45, Art. 369. Telegram from treasury department dated January 25, 1917; I. T. S. 1918, ¶ 91.

has been paid, refund may be claimed, in the manner outlined in a later chapter.[130]

When a claim for refund is filed by aliens, resident or nonresident, on Form 46, a copy of the form upon which the alien was assessed and taxed should be attached to Form 46.[131]

130 See Chapter 37.
131 O. D. 272, T. B. 18-19-488.

CHAPTER 5

RESIDENT AGENTS FOR NON-RESIDENT ALIENS AND FOREIGN CORPORATIONS—NOMINAL STOCKHOLDERS

The Revenue Act of 1921 expressly provides for the collection of the tax at the source on payment of certain specified forms of income to *nonresident aliens, partnerships composed in whole or in part of nonresident aliens and noresident foreign corporations.*[1] The persons required to withhold and account for the tax are designated in the law as withholding agents.[2] The treasury department, in addition, has followed under the 1918 Law a method of collecting the tax on income liable to pass out of its jurisdiction, which it evolved under the 1916 Law and which consists in impressing upon residents, under certain circumstances, the duty of filing returns and paying the normal tax and the surtax on any and all income of nonresident *aliens* and nonresident foreign *corporations* over which they have custody or control.[3] Under the present law this duty will also be imposed with respect to income of partnerships composed in whole or in part of nonresident aliens. Such persons are held to be agents of the nonresidents and to stand in the place of their principals.[4] A withholding agent may or may not, depending on the circumstances, be an agent within the meaning of this chapter.[5]

Lack of Authority Under Present Law. Neither the Revenue Act of 1918 nor the Revenue Act of 1921 contain any provision expressly making an agent liable for the surtax—or the normal tax upon income which is not both fixed or determinable and annual or periodical imposed upon his principal with respect to income passing through the hands of such agent.[6] The commissioner has nevertheless ruled that the responsible representa-

[1] Revenue Act of 1921, §§ 221 and 237. Partnerships were not included under the 1918 Law. Revenue Act of 1918, §§ 221, 237. Under the 1916 Law agents for foreign partnerships were not required to make any returns or pay any taxes for the foreign partnerships unless and until they were so instructed by the commissioner. (T. D. 2401.) This was because a partnership was not itself subject to tax or required to make returns.

[2] Revenue Act of 1921, § 200; Revenue Act of 1918, § 200. See Chapter 40.

[3] Reg. 45, Art. 404.

[4] Reg. 45, Art. 404; T. D. 2135.

[5] See p. 89 for a discussion of this distinction.

[6] See Revenue Act of 1916, § 9 (g). The treasury department evidently based its authority to impose upon resident agents the duties discussed in this chapter upon this section of the 1916 Law (T. D. 2452).

tives of nonresident aliens in connection with any sources of income which such nonresident aliens may have within the United States, must make a return of such income, and must pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their nonresident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. The agent of a nonresident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes.[7]

Distinction Between Withholding and Resident Agents. The distinction between withholding agents and resident agents may be indicated from two angles: (a) Their respective services in securing to the government the payment of the income tax of nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and nonresident foreign corporations and (b) the character of their respective relationships to the taxpayer for whose tax they are responsible. As appears more fully in a subsequent chapter, the provisions for the collection of the tax at the source apply only to the normal tax and then only in the case of income which is both (1) fixed or determinable and (2) annual or periodical.[8] Obviously, a large part of the income accruing to nonresident aliens, individually and in partnership, and nonresident foreign corporations from sources within the United States is not both fixed or determinable and annual or periodical, and a large part would, because of its amount (combined or not with other items of income to the same recipient from sources within the United States) be liable to the sur-

[7] Reg. 45, Art. 404. It may be argued that the commissioner has authority under § 223 of the Revenue Act of 1921 and the Revenue Act of 1918 which provides that "if a taxpayer is unable to make his own return, the return shall be made by a duly authorized agent * * * or other person charged with the care of the person or property of such taxpayer" to compel resident agents to *file returns* on behalf of their nonresident principals, but this section certainly gives no authority for imposing the duty to *pay any tax*. It seems clear that this deficiency of authority in the present law should be remedied by prompt amendment, since otherwise large sums of just taxes payable by nonresident aliens and nonresident foreign corporations may be lost to the government. A resident fiduciary is not liable for surtax on the income which it received as trustee for a nonresident alien beneficiary, under the Revenue Act of 1917, provided the income was returned for the purpose of the tax by the beneficiary. (O. D. 1011, T. B. 12-20-798.)

[8] Reg. 45, Art. 362. See Chapter 40.

taxes. The ordinary withholding provisions[9] of the present law therefore provide insufficient security for the collection of the *normal* tax upon the income of nonresident aliens and nonresident foreign corporations from sources within the United States and no security whatever for the collection of the *surtax* upon such income. The placing of a responsibility upon so-called resident agents fills this deficiency. Withholding agents insure the collection of the normal tax upon income which is both fixed or determinable and annual or periodical; resident agents insure the collection of the normal tax upon income not falling within these rigid classifications and of the surtax upon income without regard to any classification. The distinction between withholding agents and resident agents from the viewpoint of their respective relationships with the taxpayer is not so clear. A withholding agent is defined in the law[10] as "any person required to deduct and withhold any tax." In brief, a person is required to deduct and withhold the normal tax, in the case of nonresident aliens, partnerships with nonresident alien members and nonresident foreign corporations, upon the payment of fixed or determinable and annual or periodical income.[11] The relationship of the withholding agent to the taxpayer whose tax is withheld is an artificial relationship and arises in all cases where the relationship of debtor and creditor exists and the parties contemplate payment in a certain manner. As a matter of fact, a withholding agent is primarily an agent of the government, not the taxpayer. On the other hand, a resident agent's status depends neither on the relationship of debtor and creditor nor on the manner of payment contemplated for the debt. Thus, a bank is not a resident agent for its nonresident depositors where the relationship is merely that of bank and depositor[12] (i. e., ordinarily debtor and creditor), but a bank acting as the custodian of securities on which it collects and disburses interest would be a resident agent.[13] In other words, a resident agent is at least to some degree an agent of the taxpayer as well as of the government; and being an agent of the taxpayer, he must derive his appointment and authority from some act or conduct of the principal,

[9] Revenue Act of 1921, §§ 221, 237; Revenue Act of 1918, §§ 221, 237.

[10] Revenue Act of 1921, § 200; Revenue Act of 1918, § 200.

[11] Revenue Act of 1921, §§ 221, 237; Revenue Act of 1918, §§ 221, 237.

[12] Reg. 33, Art. 67; letter from treasury department dated February 8, 1917; I. T. S. 1918, ¶106.

[13] Letter from treasury department dated April 10, 1916; I. T. S. 1919, ¶ 560.

such as a power of attorney, or fiduciary relation existing between himself and the taxpayer.[14]

Definition. In order to simplify the discussion in the following pages of this chapter the term "nonresidents" will be used to include nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and nonresident foreign corporations, i. e., foreign corporations having no office or place of business in this country.

Who Are Resident Agents. A resident corporation, partnership or individual may be an agent within the meaning of this chapter. The following have been held to be such resident agents: (a) Residents acting by power of attorney for nonresidents; (b) responsible heads or representatives in charge of property owned or business carried on by non-residents in this country;[15] (c) resident nominal stockholders holding stock in their names for nonresident actual owners;[16] (d) residents having custody of securities of nonresidents on which they collect the income, both with respect to the income and with respect to any profits made from the sale of the securities;[17] (e) residents purchasing patent rights from nonresidents and paying royalty thereon;[18] (f) real estate agents managing buildings owned by nonresidents.[19] A domestic corporation purchased abroad from a foreign corporation goods at a minimum price for resale in the United States. If sold for more than the minimum price, the domestic corporation was to receive a commission and after deducting certain expenses and the commission, the net profit was divided between the domestic corporation and the foreign corporation. The share of the profits so received by the foreign corporation represents income from sources within the United States, but is not subject to the withholding provisions of the Revenue Act of 1918, since it is not "fixed or determinable income" within the meaning of the act. However, the domestic corporation acting as agent of the foreign corporation with re-

[14] The following language of Reg. 45, Art. 404, should be noted in this connection: "The agency *appointment* will determine how completely the agent is substituted for the principal for tax purposes." (See also Reg. 33, Rev., Art. 32.)

[15] Reg. 33, Art. 8; T. D. 2313.

[16] See p. 95.

[17] Letter from treasury department dated May 31, 1916; I. T. S. 1918, ¶ 105. For the purpose of reporting profits made from the sale of the securities such agents are required to obtain all facts necessary to ascertain the profit in any transaction.

[18] T. D. 2137.

[19] Letter from treasury department dated January 19, 1915; I. T. S. 1918, ¶ 99.

spect to goods sold in the United States must file a return of income for the foreign corporation and pay any tax found to be due.[20] An insurance broker in the United States who solicits and procures insurance in nonresident alien corporations, collects the premiums thereon, and credits the account of the respective corporations with the net proceeds after deductions for losses are made, is considered the resident agent of such foreign corporations with respect to the business obtained through his efforts. Where the insurance broker transacts business in the United States for certain nonresident foreign corporations and pays the premiums to a nonresident alien individual who acts as agent for the nonresident foreign corporations it has been held that the insurance broker must file returns for each nonresident foreign corporation, covering the gross income received from sources within the United States within the purview of his agency, claiming therein any deductions to which the corporations are entitled by reason of losses sustained and pay the total tax due thereon.[21]

Who Are Not Resident Agents. The following have been held not to be resident agents within the meaning of this chapter: (a) Corporations paying interest on their own bonds or dividends on their own stock to nonresidents, bondholders or stockholders, although they are withholding agents for the purpose of collection of the tax at the source; (b) resident debtors, individual or partnership, although they are required to withhold the tax at the source on interest paid to nonresident aliens; (c) banks, where their relation to their nonresident depositors is merely that of bank and depositor;[22] (d) banks receiving interest or dividends direct from domestic corporations to be credited to the accounts of nonresident depositors;[23] (e) banks holding for the account of foreign banks and bankers securities on which they collect and disburse interest to the foreign banks and bankers;[24] (f) an individual, partnership, or corporation, occupying or standing in the ordinary relation of broker towards a

[20] O. D. 384, T. B. 4-20-708.

[21] O. D. 586, T. B. 28-20-1062.

[22] Banks are held not to be withholding agents with respect to interest paid on deposits. (Reg. 33, Art. 67.)

[23] Letter from treasury department dated February 8, 1917; I. T. S. 1918, ¶ 106.

[24] Letter from treasury department dated April 10, 1916; I. T. S. 1919, ¶ 560. Where the bank however acts as custodian of securities for nonresidents other than banks it seems that it is a resident agent. Rulings however are not clear or consistent on this point.

nonresident as client, although he or it may be required to withhold the tax as a withholding agent.[25]

Duties and Liabilities of Resident Agents. The responsible heads or representatives of nonresident aliens in connection with any sources of income which such nonresident aliens may have within the United States, are required to make a return of such income and to pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their nonresident alien principals, in all cases where the income tax on income so in their receipt, custody, or control shall not have been withheld at the source.[26] They are under no duty to inquire into or report any income of the nonresident principal received from other sources in this country, but may, if authorized by the nonresident principal, make a complete return of all income from sources within this country. Where the same nonresident has several agents, none of whom is authorized to make a return of all the principal's income, each agent reports separately the income coming into his hands, and the treasury department takes into consideration the aggregate amount of net income covered by all of the returns, in assessing the tax, making a further assessment to cover any surtax which may be due, in the case of individuals, on the aggregate income.[27] Of course, if the nonresident principal files a return of all his income from sources within this country, the agents are not also required to file returns. Resident agents, therefore, ascertain in due time whether or not their nonresident principals intend to report their income from sources within the United States and to pay the tax due thereon, and govern themselves accordingly.

Procedure in Collecting Income for Nonresidents. In collecting income subject to withholding of the tax at the source, the resident agent is required to execute the ownership certificate required of his nonresident principal, signing it with the name of the principal and affixing his own signature as agent.[28] In brief, with respect to such income, he is required to proceed as if he

[25] Letter from treasury department dated April 17, 1918; I. T. S. 1921, ¶ 1723. In the hypothetical case upon which this ruling was based the nonresident client maintained an account with the broker, occasionally buying some securities on margin and selling some from time to time, interest being charged on balances due and dividends as paid on the stocks carried and credited to the account. All dealings were in response to directions from the nonresident.

[26] Reg. 45, Art. 404; Reg. 33 Rev., Art. 32.

[27] Letter from treasury department dated March 6, 1917; I. T. S. 1918, ¶ 114.

[28] See Chapter 40.

were the nonresident principal, in whose place he stands for the purpose of the income tax. The fact that the nonresident has an agent here does not relieve his income from withholding at the source when paid to such agent. The appointment by a nonresident alien banking corporation of a resident agent in the United States who has authority to make returns for the corporation will relieve a domestic bank from the responsibility of withholding the tax from the interest credited to the account of the foreign bank provided the agent furnishes a certificate stating that the foreign corporation has an office or place of business in the United States and that he will make all necessary returns and pay the taxes shown to be due.[29]

Making Returns for Nonresident Principal. In making the annual return for his nonresident principal a resident agent is required to use the same form as would be used by the principal[30] and follow the provisions of the law and the regulations relating to nonresident aliens or foreign corporations, as the case may be, in claiming deductions. In the affidavit at the end of the individual's form, to be executed by the agent, a statement is required to be made that the return covers only the income received by the agent, or that it covers all the income of the principal from sources within the United States, as the case may be. The affidavit on the corporation's form is prepared for execution by two officers of the corporation, when the return is signed by an agent for a foreign corporation, an affidavit that he is the properly authorized agent, and that the report covers income from all sources within the United States, or income passing through his hands, as the case may be, is required to be attached to the return and duly executed. The return may be filed in the district in which the agent resides or has his principal place of business.

Paying the Tax for Nonresident Principal. Under the 1918 Law the tax of a nonresident became due and payable at the same time and in the same manner as the tax of a resident, and might be paid in the same way.[31] Under the present law the tax on

[29] O. D. 358, T. B. 1-20-661.

[30] See Chapter 34 for forms.

[31] A special ruling was made to cover cases in 1916, where the agent for a nonresident alien had received income from corporate interest or dividends and paid the same over to his principal prior to September 8th. In such cases, if the agent did not have, between September 8th and the end of the year, any income of the nonresident alien from which to pay the tax he was relieved from liability, leaving the tax a charge against the nonresident alien to be collected direct from him by the treasury department, (T. D. 2402.) A like special ruling was made to cover cases in 1917 where

nonresidents does not become due and payable until three months after the due date for residents. Upon paying the tax, the agent may demand a separate receipt for the amount paid on behalf of his nonresident principal, and such receipt is sufficient evidence to justify the agent in withholding the amount therein stated from his next payment to the principal, if he has not already withheld an amount sufficient to satisfy the tax. The principal may demand this receipt from the agent upon giving him a full written receipt acknowledging the payment of the tax as a satisfaction of the agent's debt to that extent.[32]

Nominal Stockholders. For convenience in handling financial transactions, stock certificates are sometimes issued in the names of others than the actual owners of the stock. The individuals, partnerships or corporations so holding the nominal title to the stock are known as nominal stockholders or stockholders of record.[33] A nominal stockholder is not a withholding agent, although under the 1916 Law he might have been one if the actual owner was a nonresident foreign corporation. The distinction between a nominal stockholder and a fiduciary lies in the fact that the latter holds legal title to stock (if that is the subject of the trust), while a nominal stockholder may hold no title at all, the stock merely standing in his name on the books of the corporation. Nominal stockholders may acquire their status by arrangement with the actual owners, as where a broker carries in his name the stock of a customer, in which event the name and status of the actual owner is known; but in some cases the names of the actual owners may not be known to the nominal stockholder as, for instance, where the actual ownership is evidenced by bearer certificates.[34] In other cases, notably when large amounts of stock are left in the names of stock exchange

the agent for a nonresident alien had received income and paid the same over to his principal prior to October 3, but where the agent received the income of his principal subsequent to October 3 he was obliged to pay the total tax due for the entire year 1917 and subsequent years. (Reg. 33 Rev., Art. 32.) As the 1918 Law did not go into effect until February 25, 1919, the agent would undoubtedly only be held for tax on income passing through his hands up to that date, at the rates prescribed by the Revenue Act of 1916. Under the present law no change in rates occurs until January 1, 1922, and the same rule should apply. (See Reg. 45, Art. 361, where this situation is treated in connection with the collection of the tax at the source.)

[32] Revenue Act of 1921, § 251; Revenue Act of 1918, § 251.

[33] They are generally called "record owner" in the regulations. See Reg. 45, Art. 405.

[34] The procedure under the 1916 Law applicable to such situations is indicated at the end of this chapter.

houses, one may become a nominal stockholder without knowing the identity of the actual owner. Thus, stock certificates endorsed in blank by an actual owner, and sold on the market, may pass by delivery to several consecutive purchasers before the stock is transferred on the books of the corporation. In such cases, the original transferor remains the record owner until the transfer is made on the corporate books, and, as such, he is presumed to be the real owner of dividends declared on the stock, unless he proves that actual ownership of the stock does not rest in him.[35] If, however, a nominal stockholder not only parts with the certificate of stock, endorsed in blank, but also gives the corporation a "dividend order" to pay dividends to another, his responsibility for tax on such dividends ceases, and the one to whom the corporation pays the dividend becomes liable for any tax thereon, unless he in turn shows that actual ownership does not rest in him. A nominal stockholder receiving dividends and paying them over to one claiming to be the actual owner is required to ascertain the name and address of such claimant and proceed as indicated below.[36]

APPLICATION OF 1918 LAW AND PRESENT LAW TO NOMINAL STOCKHOLDERS. The treasury department based its authority for the rules and regulations issued under the 1916 Law in regard to withholding on dividend income against nonresident foreign *corporations* on the basis of apparent ownership, upon the provision[37] of the 1916 Law that "all the provisions of this title relating to the tax authorized and required to be deducted and withheld and paid to the officer of the United States government authorized to receive the same from the income of nonresident alien individuals from sources within the United States shall be made applicable to income derived from dividends upon the capital stock or from the net earnings of domestic or other resident corporations, joint-stock companies or associations, and insurance companies by nonresident alien companies, corporations, joint-stock companies, or associations, and insurance companies not engaged in business or trade within the United States and not having any office or place of business therein." This provision was separate from and additional to the general withholding provision[38] of the 1916 Law which expressly excepted

[35] Letter from treasury department dated December 28, 1916; I. T. S. 1918, ¶ 274.

[36] The regulations on this subject refer only to dividends of domestic corporations and resident foreign corporations. Reg. 45, Art. 404.

[37] Revenue Act of 1916, § 13 (f).

[38] Revenue Act of 1916, § 9 (b).

from its scope "income derived from dividends on capital stock, or from the net earnings of a corporation, joint-stock company or association, or insurance company, which is taxable upon its net income as provided in this title." The treasury department based its authority for requiring the tax to be paid on dividend income of nonresident alien individuals by nominal stockholders or record owners upon the provision[39] of the 1916 Law that "the intent and purpose of this title is that all gains, profits, and income of a taxable class, as defined by this title, shall be charged and assessed with the corresponding tax, normal and additional, prescribed by this title, and said tax shall be paid by the owner of such income, or the proper representative having the receipt, custody, control, or disposal of the same." The general withholding provision[40] of the Revenue Act of 1918 expressly excepted from its scope "income received as dividends from a corporation which is taxable under this title on its net income," and contains no provision corresponding to the provision of the 1916 Law quoted above applying its general withholding requirements to income derived from dividends received by nonresident foreign *corporations* or making an agent liable for the surtax imposed upon his principal with respect to income *passing through the hands of such agent.* The 1918 Law does provide for withholding in the case of dividends other than those included in the above exception, but as such other dividends would not be taxable in the hands of nonresidents, the law in that respect appears to be an anachronism. The reason for the failure (with the exception just mentioned) of the 1918 Law to provide for withholding against nonresident foreign *corporations* as to income derived from dividends is that foreign corporations, as well as domestic corporations, were entitled to deduct from gross income, in computing net income, "amounts received as dividends from a corporation which is taxable upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by act of Congress."[41] Under the 1918 Law, in practical effect, no withholding from corporate dividends was required in any case,[42] and the responsibility of a nominal stockholder pertained only to the surtax for which a nonresident individual actual owner might be liable. He was a resident agent

[39] Revenue Act of 1916, § 9 (g).

[40] Revenue Act of 1918, §§ 221 and 237.

[41] Revenue Act of 1918, § 234 (a) 6 and (b). Reg. 45, Art. 363.

[42] See p. 88 in regard to the deficiency of authority in the commissioner under the present law in this connection.

within the meaning of this chapter as to dividend income, but since the dividends of domestic or resident corporations were in no case subject to the normal tax, his liability was somewhat narrower than the liability of other resident agents.[43]

A full discussion of the taxability, under the present law, of dividends in the hands of nonresidents is contained in the preceding chapter and it will be seen from that discussion that the duties of withholding agents and resident agents with respect to income from dividends will be the same under the present law as under the 1918 Law.

PROCEDURE WHEN NOMINAL STOCKHOLDER IS A RESIDENT AND ACTUAL OWNER IS A RESIDENT. In cases where both the nominal stockholder and the actual owner are residents of the United States, the nominal stockholder is not required to obtain any certificate disclosing the name of the actual owner. The primary purpose of requiring disclosure of the actual owner is to assist in administering that provision of the law which makes dividends on the stock of domestic or resident foreign corporations liable to surtax when paid to nonresident alien individuals.[44] The actual owner is, of course, in all cases obligated to report the dividends and pay the surtax thereon, if he is liable; the nominal stockholder is under no duty to report the dividends as his income, but should be prepared to show conclusively, if question arises, that actual ownership does not rest in him.[45] If a nominal stockholder pays over the dividends to a resident whom he knows to be the agent of a nonresident alien, he is under no duty as agent, since it is the one who collects the dividend for a nonresident, or who finally pays it over to a nonresident, who has impressed upon him the duty of a resident agent.

PROCEDURE WHERE NOMINAL STOCKHOLDER IS RESIDENT AND ACTUAL OWNER IS NON-RESIDENT.[46] In this case it is immaterial whether the nominal stockholder is an individual, partnership, or corporation, since irrespective of his or its individual or corporate status, the nominal stockholder may be held responsible as resident agent for the surtax payable by the actual owner upon dividends. It was ruled under the 1918 Law that in all cases where

[43] See letter from treasury department dated November 21, 1916; I. T. S. 1918, ¶ 272, dealing with the 1916 Law.

[44] Letter from treasury department dated November 21, 1916; I. T. S. 1918, ¶ 272.

[45] Letter from treasury department dated November 21, 1916; I. T. S. 1918, ¶ 272.

[46] For the procedure under the 1916 Law see Reg. 33 Rev., Arts. 32 and 201; T. D. 2301; letter from treasury department dated June 6, 1918; I. T. S. 1918, ¶ 3528.

the actual owner is a nonresident alien *individual* and the record owner is a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control and disposal of the dividend income and will be required to make return for the actual owner, regardless of the amount of the income, and to pay any *surtax* found by such return to be due.[47] If the actual owner is an individual, the return made by the nominal stockholder on his behalf may show that a surtax is due, since individuals are liable to the surtax. If, however, the actual owner is a partnership or corporation, the return made by the nominal stockholder on its behalf will not show any surtax to be due, since partnerships are not subject to any income tax as such,[48] and corporations are not liable to the surtax.[49]

PROCEDURE WHERE NOMINAL STOCKHOLDER IS NON-RESIDENT AND ACTUAL OWNER IS RESIDENT.[50] In this case, whether the actual owner is an individual, partnership, or corporation is immaterial, since the *residence* of the actual owner within the United States dispenses with the necessity of impressing the duty of the resident agent on the nominal stockholder. It was ruled under the 1918 Law that dividends on the stock of domestic or resident foreign corporations are *prima facie* income of the record owner of the stock, and such record owner will be liable for any additional tax based thereon, unless a disclosure[51] of the actual ownership is made to the commissioner which shall show that the record owner is not the actual owner and who the owner is and his address.[52] If the nominal stockholder is an individual and fails to make this disclosure, the dividends will, therefore, be subject to surtax as if they belonged to the individual nominal stockholder. If the nominal stockholder is a partnership, and fails to make such disclosure, the dividends will be regarded as income[53] of the partnership, to be reported in the information return of the partnership, and such dividends will ultimately be subject to surtax in the hands of the individual partners. If the nominal stockholder is a corporation and fails to make such disclosure, the dividends will be regarded as income of the corporation. But since dividends paid by domestic or resident foreign corporations are deductible from gross income when

[47] Reg. 45, Art. 405.

[48] Revenue Act of 1921, § 218; Revenue Act of 1918, § 218.

[49] Reg. 33, Art. 185.

[50] See Note 46.

[51] This disclosure is made on Form No. 1087 (revised).

[52] Reg. 45, Art. 405.

[53] Revenue Act of 1921, § 224; See Revenue Act of 1918, § 224.

received by corporations, domestic or foreign,[54] they will not be *taxable* income in this event and it follows that a corporation need not make such disclosure.

PROCEDURE IN CASE OF DUTCH ADMINISTRATION OFFICES. Under the 1916 Law a special ruling having application to many similar situations in foreign countries was made with respect to the so-called "Administration Offices" in Holland. It appears that the Dutch Administration Offices are the registered owners of large blocks of American stocks, against which they have issued bearer certificates, with coupons attached. These coupons, upon presentation and surrender, entitle the bearer to dividends declared on the stocks. The administration offices were held to be prima facie liable for the tax on dividends paid on the stock standing in their names, unless they disclosed the names of the actual owners by use of the proper certificates.[55] By appointing an agent in the United States they could avoid having the tax withheld at the source. Such agent was required to make returns of income for the Dutch administration office represented by him and pay the corporation tax of 2% on all dividends received by it, except such amounts as were shown by certificates disclosing actual ownership to have been received for the account of nonresident alien individuals or partnerships. Such certificates were attached to and made the basis of the return when filed.[56]

CERTIFICATES ISSUED TO BEARER. When stock of an American corporation is floated in some European countries, where investors are accustomed to bearer stock certificates, a block of the stock is sometimes issued to a trust company *in this country* which in turn issues bearer certificates entitling the holder to certificates of stock for the number of shares designated, upon the surrender of the bearer certificates, and to any dividends which may be declared on such shares while the bearer certificate is outstanding. The bearer certificates pass by delivery, the dividends being claimed through foreign banks by presentation and surrender of numbered coupons, attached thereto. In such cases the trust company was, under the 1916 Law, in the position of a resident nominal stockholder. Under the present law the rule

[54] Revenue Act of 1921, § 234 (a) (6); Revenue Act of 1918, § 234 (a) 6, (b).

[55] Disclosure was made on Form No. 1087.

[56] T. D. 2386; T. D. 2669. This ruling was based on the theory that the Dutch Administration offices were "nonresident alien corporations," subject to tax on dividends and to having the tax withheld at the source. Since the Revenue Acts of 1918 and 1921 do not tax corporations on dividends received by them, it seems that only on some other theory can they be required to ascertain and disclose the names of the owners of their bearer

would still seem to apply, and where the actual owner is a nonresident alien individual the trust company will be required to make return for such actual owner and pay the surtax found to be due.[57]

certificates, under the present law. Neither the law nor the latest regulations have provided for the case of a foreign corporation nominal stockholder and a nonresident alien actual owner.

[57] See Reg. 45, Art. 405. Form 1087 should be used to disclose actual ownership when the owner is a nonresident alien.

CHAPTER 6

FIDUCIARIES

The Revenue Acts of 1918 and 1921 have in general clarified rather than changed the provisions of the 1916 Law fixing the special duties and responsibilities of fiduciaries. Fiduciaries are classed as individuals under the law, irrespective of their status, individual or corporate, and may be required to make returns of income or returns of information, according to the character of their relationship with their beneficiaries or the nature of the income constituting the subject of the trust. In certain cases trust estates are taxed as entities in which cases the fiduciary is required to pay the tax for the estate; in other cases the law, ignoring the entity of the trust estate, taxes the income in the hands of the beneficiary, in which event the fiduciary is not required to pay any tax upon the estate. The Revenue Act of 1921 contains a new provision concerning trusts, part of the income of which is distributable and part of which is to be held for future distribution[1] as well as a provision with respect to trusts created by employers as part of a stock bonus or profit-sharing plan.[2] The provisions of law and regulations pertaining particularly to fiduciaries and trust estates are indicated below.

Trusts Created by Employers. The Revenue Act of 1921 contains a new provision with respect to trusts created by employers as a part of a stock bonus or profit-sharing plan for the benefit of employees. It provides that a trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable as an estate or trust, but the amount actually distributed or made available to any distributee will be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees will for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the items ordinarily allowed as credits to individuals.[3]

[1] Revenue Act of 1921, § 219 (e).
[2] Revenue Act of 1921, § 219 (f).
[3] Revenue Act of 1921, § 219 (f).

Who Are Fiduciaries. The term "fiduciary" is defined to mean a "guardian, trustee, executor, administrator, receiver, conservator, or any *person* acting in any fiduciary capacity for any person, trust or estate."[4] In view of the definition of the word "person" used in this definition,[5] a corporation, partnership, joint-stock company or insurance company may be a fiduciary under the law. It has been held that a fiduciary for income tax purposes is one who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest, or receives and controls the income of another, as in the case of receivers.[6] It has also been ruled that the term, "fiduciary" applies to all persons or corporations who occupy positions of peculiar confidence towards others, such as trustees, executors, or administrators.[7] Some rulings and regulations issued in explanation of the term "fiduciary" are given below as indicative of the treasury department's attitude in interpretation of the broad term "any person acting in any fiduciary capacity for any person, trust or estate."

AGENTS. An agent, as such, is not a fiduciary for his principal even though he may have complete charge of the property of his principal.[8] There may be a fiduciary relationship between an agent and a principal, but the word "agent" standing alone does not denote a fiduciary within the meaning of the law.[9] An oral agreement whereby one of a number of brothers and sisters acts as agent for all of them in managing property held by them as tenants in common under the father's will, and in distributing the income therefrom, is not a legal trust for income tax purposes, nor is the agent a fiduciary. Each principal should file a separate return, including therein his share of the income from the property and claiming a proportionate share of any allowable deductions.[10] By an agreement addressed to a certain company setting forth that the persons signing such agreement are the owners of a royalty interest in certain oil wells, each

[4] Revenue Act of 1918, § 200; Revenue Act of 1921, § 200. This definition is the same in both laws and the rulings discussed below, issued under the 1918 Law, should be applicable under the present law.

[5] In the Revenue Act of 1921, § 2, and in the Revenue Act of 1918, § 1, the term "person" is defined to include "partnerships and corporations, as well as individuals." The term "corporation" includes associations, joint-stock companies and insurance companies.

[6] Reg. 45, Art. 1521; T. D. 2090.

[7] Reg. 45, Art. 1521; Reg. 33 Rev., Art. 29.

[8] Reg. 45, Art. 1522; T. D. 2135.

[9] Reg. 45, Art. 1522; Reg. 33 Rev., Art. 29; T. D. 2090.

[10] O. D. 425, T. B. 13-20-814.

owning the respective interest set opposite his name, and that on account of the diversity of ownership in said property it is impracticable for the signers, as well as for the company as purchaser of the oil and gas, to keep separate books of account showing the respective interests of the several owners, an individual was selected and appointed as trustee of the owners to collect from the purchaser of the oil and gas any and all moneys arising from the sale of oil and gas from the property and to account therefor to them. The trustee was also given authority to sign division orders respecting the sale and the running of oil and gas from the land. It has been held that as no property was conveyed to the individual named as trustee by the agreement, his duties being merely to receive from the company income payable to the signers of the agreement, to account to such signers for the income so received and to sign division orders, he is not a trustee within the meaning of the law, but an agent of the persons signing the agreement. He is not, therefore, required to make a return, either of income or of information, as a fiduciary.[11]

Power of Attorney. A person cannot, by power of attorney, appoint another to act as a fiduciary. A power of attorney cannot create a fiduciary relationship. An agent having entire charge of property with authority conferred upon him by a power of attorney to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, paying taxes and expenses and all other charges in connection with the property out of funds in his hands from the rents collected, merely turning over the net profits from the property periodically to his principal is not a fiduciary. In cases where no legal trust has been created in the estate controlled by the agent and attorney, the liability under the law to make returns and pay the taxes rests with the principal.[12]

Guardians. A legal guardian is a fiduciary, but it does not seem that a natural guardian comes within the definition. Under the Revenue Acts of 1918 and 1921 minors are required to file returns, but if a minor is dependent upon his parent, who appropriates or may appropriate his earnings, such earnings are income of the parent and not of the minor for the purpose of the normal tax and surtax. In the absence of proof to the contrary a parent will be assumed not to have emancipated his minor child and must include in his return any earnings of the minor.[13] It

[11] O. D. 875, T. B. 16-21-1569.

[12] Reg. 45, Art. 1522; Reg. 33 Rev., Art. 29; T. D. 2137.

[13] Reg. 45, Art. 403.

seems, therefore, that if a minor exercises independent control of any of his own income, the guardian should not make a separate return for the minor of income from a separate estate nor should the parent include the minor's income in his own return.

ANCILLARY ADMINISTRATOR. An ancillary administrator is merely an agent of the domiciliary administrator and should transmit to him all information as to income of the estate received by the ancillary administrator, to the end that the original administrator may make a return covering the entire income of the estate.[14]

TRUSTEES IN BANKRUPTCY. A trustee in bankruptcy is a fiduciary and is required to file a return for the bankrupt estate if its net income exceeds the specific exemption of $1000.[15]

RECEIVERS. A receiver for an individual is a fiduciary, but it seems that a receiver for a corporation is not,[16] notwithstanding the broad definition[17] of the words "fiduciary" and "person" and the general provisions of the law[18] governing fiduciaries.[19] Receivers appointed by authority of law, in possession of part only of the property of an individual, are expressly excepted from the requirement that fiduciaries shall make returns.[20]

TEMPORARY RECEIVER HELD TO BE FIDUCIARY. Under the 1916 Law it was held that one appointed under interlocutory orders of the United States district court to act as receiver of an individual in a proceeding wherein certain persons complaining as creditors were seeking to have the property of the individual distributed among them, was a fiduciary, notwithstanding that title to the property in question (cash and securities) remained in the individual sued and that his possession and right to deal with the same were only suspended. The receiver, having re-

[14] Reg. 33 Rev., Art. 180.

[15] O. D. 174, T. B. 7-19-297.

[16] Reg. 45, Art. 424. See letter from treasury department dated February 27, 1915; I. T. S. 1917, ¶ 597, and letter from treasury department dated June 22, 1916; I. T. S. 1918, ¶ 1097.

[17] Revenue Act of 1921, §§ 2 and 200; Revenue Act of 1918, §§ 1 and 200.

[18] Revenue Act of 1921, §§ 219 and 225; Revenue Act of 1918, §§ 219 and 225.

[19] This is true because it is specifically provided elsewhere that receivers, trustees in bankruptcy, or assignees operating the property or business of corporations shall make returns for such corporations in the same manner and form as corporations are required to make returns, and that any tax due on the basis of such returns will be collected in the same manner as if collected from the corporations of whose business or property they have custody and control. (Revenue Act of 1921, § 239; Revenue Act of 1918, § 239.)

[20] Revenue Act of 1921, § 225; Revenue Act of 1918, § 225.

ceived income from the property in his possession, was required to file a return as a fiduciary.[21]

Mortgage Foreclosure Receivers. A receiver, appointed in a mortgage foreclosure action in the state of New York by a court of equity in aid of its jurisdiction, who is not a receiver of all the property of the mortgagor corporation, but is a common-law receiver in charge of only a part of the mortgaged property of the corporation and a receiver merely of the rents and profits of such mortgaged property, need not file a return of income but he is required to file a return of information at the source.[22]

Committee for an Incompetent. The committee for the property of an incompetent person is regarded as a fiduciary.[23]

Deeds of Trust. A deed of trust must be absolute so far as the conveyance of title is concerned and irrevocable by the donor, otherwise the income from the property in question will accrue to the donor and must be accounted for by him.[24] Where a person transfers funds or property to trustees to pay to him during his lifetime so much of the income as he may demand and from time to time as much of the principal as such trustees might deem advisable, all unwithdrawn income at the date of the death of the settlor to become a part of the trust fund, the settlor should return in any one year all the income accruing from such trust fund whether actually withdrawn by him or not. The trustees under such deed must make return of all income from the trust, but are relieved from paying a tax thereon.[25]

Where under the terms of an irrevocable trust the income from the trust property was to be paid to the donor during her life and upon her death to certain named persons or institutions, or to such other persons or institutions as the trustee should see

[21] Letter from treasury department dated January 22, 1917.

[22] Reg. 45, Art. 424. Letter from treasury department dated May 1, 1918; I. T. S. 1919, ¶ 1433. This letter stated that the same ruling extended to receivers of partnerships under the excess profits tax. It was first held by the treasury department under the 1916 Law that a receiver in foreclosure proceedings of the rents, issues and profits of mortgaged premises, even though for only a part of the property of the mortgagor, was required to file a return of income, reporting the entire operations transacted by the receiver during the year 1917. Upon further consideration the treasury department changed this ruling to that stated in the text above. (Letter from treasury department dated March 28, 1918; I. T. S. 1918, ¶ 3293.)

[23] Reg. 45, Art. 1521; Reg. 33 Rev., Art. 29. Letter from treasury department dated February 21, 1916; I. T. S. 1918, ¶ 128. Letter from treasury department dated May 1, 1918; I. T. S. 1919, ¶ 1433.

[24] Reg. 45, Art. 341; Reg. 33 Rev., Art. 29.

[25] S. 1344, T. B. 10-20-780; O. D. 621, T. B. 32-20-1116.

fit and in such amounts as he might deem proper, the trust property to be sold upon the death of the trustee and the proceeds distributed among certain named persons or institutions, it was held that during the life of the donor the entire income of the trust was taxable to her whether distributed or not, inasmuch as it was distributable to her. If the net income of the estate was $1,000 or more, Form 1041 should have been filed by the trustee. All income received after the death of the donor and during the life of the trustee is to be entirely distributed and if any beneficiary is not exempt, he must include in his income tax return all income received in any year. If the trustee fails to distribute the entire income and the amount so retained is $1,000 or more, Form 1040 must be filed and payment made of any tax found to be due. If the entire net income of the trust estate for any year is $1,000 or more, a return on Form 1041 must be filed to show the amount of net income distributed to each beneficiary and to show any amount retained by the estate.[26]

Where a declaration of trust provides that during the life of the donor he may indicate the manner in which the trustee shall exercise the powers conferred by the trust agreement; that the donor shall have a voice in determining the amount of net income to be distributed to the beneficiaries; and that the estate created and the interests vested thereunder shall be subject to revocation by the donor at any time, in whole or in part, it is held that the amount of income received by the beneficiaries is in the nature of a gift, and that the trustee merely acts as agent for the donor. The income of the trust should therefore be included in the gross income of the donor. The trustee should file a return for the trust on Form 1041, revised, showing the grantor as beneficiary under the trust and the grantor should include the net income of the trust in gross income in his individual return under the item of income from fiduciaries.[27]

Alien Property Custodian. The alien property custodian appointed by the President during the war, under the authority of the Trading With the Enemy Act, is not a fiduciary within the meaning of the law, but is a mere official of the government, or agent of the President in taking over and preserving the property of alien enemies and is therefore not required to make return or pay taxes in behalf of alien enemies whose money or property is taken over by him. This does not mean that if income shall have accrued during the period when the property

[26] O. D. 749, T. B. 50-20-1344.
[27] O. D. 676, T. B. 40-20-1224.

has been held by the alien property custodian the former alien enemy owners are not liable for tax. Before paying out any funds representing such income, the treasury department may ascertain the taxes due and require them to be paid.[28]

Who Are Beneficiaries. A beneficiary within the meaning of the law and regulations and in the sense used in this book is the ward, *cestui que trust,* legatee, distributee, creditor, or other person entitled to any part of the net income of a trust or estate in the charge of a fiduciary. The trust estate itself is the beneficiary with respect to (1) income received by estates of deceased persons during the period of administration or settlement of the estate and not properly credited to any legatee, heir, or other beneficiary; (2) income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests; (3) income held for future distribution under the terms of the will or trust.[29]

Duties of Fiduciaries Generally. Every fiduciary is required by the law to make under oath a return for the individual, estate or trust for which he acts.[30] This return may be of two kinds: (a) a return of *income,* or (b) a return of *information,* according to the nature of the income constituting the subject of the trust. If the income is (1) received by estates of deceased persons during the period of administration or settlement,[31] and not properly paid or credited to any legatee, heir, or other beneficiary during that period, (2) accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, or (3) held for future distribution under the terms of the will or trust, the return is one of *income.* If the income (4) is to be distributed to the beneficiaries periodically, whether or not at regular intervals, (5) is collected by the guardian of an infant to be held or distributed as the court may direct, or (6) is properly paid or credited to any legatee, heir, or other beneficiary during the period of administration or settlement of an estate, the fiduciary's return is merely an *information* return. It is the duty of every fiduciary who is required to make a return of *income* to pay the tax computed in the return

[28] Op. A. G. 2, T. B. 30-20-1092.

[29] See Revenue Act of 1921, § 219, and Revenue Act of 1918, § 219.

[30] Revenue Act of 1921, § 225; Revenue Act of 1918, § 225.

[31] The "period of administration or settlement of the estate" is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates. (Reg. 45, Art. 343.)

to be due. Cases in which the fiduciary is required to *pay the tax* are divided into two classes: (1) Cases in which, by reason of the nature of the income constituting the subject of the trust, the tax is imposed upon the trust estate as an entity and the fiduciary's return is one of income, and (2) cases in which the fiduciary's return is merely one of information but, by reason of the status of the beneficiary, the tax, although laid upon the beneficiary, must be paid by the fiduciary on his behalf.

DUTIES OF RECEIVERS. Receivers who, as officers of a court, stand in the stead of some principal, are required to account for income tax as the principal would be required to account.[32] Where a receiver for an individual, acting under interlocutory orders of the court, receives income during any year or funds which he holds in trust as such receiver, such income must be accounted for and the tax paid thereon for that year. Having been thus freed from tax liability, the income assumes the status of capital and may thereafter be distributed by the receiver in the same manner as other capital. The fact that all or any part of the income received by a receiver may be used to pay creditors does not relieve the receiver from first paying the tax on all income received by him, since the government has a prior lien for the amount of the tax and only what remains after the tax is paid may be distributed to creditors or others.[33]

DUTIES OF EXECUTORS AND ADMINISTRATORS. In addition to the duties of fiduciaries generally, executors and administrators are charged with the duty of making returns of income of the decedent for the period during which he lived and made no return prior to his death.[34]

[32] Reg. 45, Art. 424; Reg. 33 Rev., Art. 26. Form No. 1040 (revised) or 1040A (revised) is used by a receiver for an individual. The 1916 Law contained a general provision (Revenue Act of 1916, § 9 (g)) which charged all gains, profits and income of a taxable class with the corresponding tax, and provided further that such tax should be paid by "the owner of such income, or the proper representative having the receipt, custody, control or disposal of the same." The Revenue Acts of 1918 and 1921 contain no similar provision. However strong the implication may be that receivers are to pay the tax on income of the persons for whom they act, the absence of a mandatory provision imposing this duty and indemnifying them against all claims and demands of every beneficiary for all payments of taxes they are required to make, may place receivers in embarrassing situations, since they are held rigidly to account for all their acts, and any moneys paid out under doubtful authority may involve them in personal liability. The same considerations apply to guardians.

[33] Letter from treasury department dated February 9, 1917; I. T. S. 1919, ¶ 1242.

[34] See p. 146 for a more complete statement of this liability.

Income of Estates and Trusts. The income of estates and trusts received during any taxable year is subject to tax either (a) in the hands of the beneficiaries on their respective shares paid or credited to them by the fiduciary during the year or (b) in the hands of the fiduciary, if the income is not paid or credited to a beneficiary. In other words, all or a part of the net income of an estate or trust may be distributable to beneficiaries[35] and if so, there is to be included in computing the net income of each beneficiary his distributive share, whether distributed or not, and the fiduciary is required to make a return showing the net income of the estate or trust and the distributable shares of each beneficiary. The fiduciary's return is one of information and he is not required to pay any tax unless the beneficiary is a nonresident alien, a minor, an incompetent, or otherwise incapacitated. On the other hand, all or a part of the net income of an estate or trust may be retained for future distribution and at the end of the year added to the corpus of the estate.[36] Such income is taxed to the fiduciary and he is required to file a return showing the amount thereof and the tax due thereon, just as individuals are required to report income and pay the tax.[37] If part of the income is distributable and part is retained by the estate, the tax is imposed on the respective parts as above indicated, the fiduciary, under the present law, being required to make a return of the entire income and being allowed to deduct the amount of distributable income.[38] Where the same trustee is designated in a will to administer several trusts, the accumulated income of each separate trust will be taxable as an entity, not the income of the trusts combined.[39]

A testator by his will directed that his executor pay an annuity to two individuals jointly during their joint lives and a like amount to the survivor during his life. As no provision

[35] Income to be distributed to beneficiaries periodically, whether or not at regular intervals, income collected by the guardian of an infant to be held or distributed as the court may direct, or income properly paid or credited to beneficiaries during the period of administration or settlement of an estate, is here referred to.

[36] Income received by estates of deceased persons during the period of administration or settlement (not paid or credited as indicated in note 35), income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, or income held for future distribution under the terms of the will or trust, is here referred to.

[37] Revenue Act of 1921, § 219; Revenue Act of 1918, § 219; Reg. 45, Arts. 341 to 346, incl., and Arts. 421 to 425, incl.

[38] Revenue Act of 1921, § 219 (e).

[39] O. D. 316, T. B. 26-19-592.

was made as to a fund from which this annuity was to be paid, the executor purchased out of the funds of the estate a single-payment two-year term endowment insurance policy covering the life of another individual. The policy provided that at its maturity the insurance company would enter into a trust agreement to retain the proceeds of the policy, pay over to the annuitants the amount of the annuity, and at their deaths to distribute the principal and any accrued income among the residuary legatees. As the amount of the annuity may reasonably be expected to be earned by the principal of the trust fund, no part of the corpus of the estate would be distributed. It has been held that the amounts received by the annuitants are not received by bequest nor are they a return of capital invested by them nor proceeds of an insurance policy exempt under the law,[40] but income received from a trust and taxable as such. It was also held that the amount by which the proceeds of the policy upon its maturity exceeded its cost is income to the insurance company in its fiduciary capacity and should be included in its return for the year in which the policy matured. The entire amount paid over to the residuary legatees upon the death of the annuitants will be exempt from income tax in the hands of the residuary legatees.[41]

Corpus of Estates and Trusts. The corpus, that is, the amount of capital transferred to the estate or trust at the time of its creation is not income.[42] In the case of estates of deceased persons, the appraised value of the property at the time of the death of the decedent is capital, regardless of the fact that the cost of that property to the decedent may have been less than such appraised value. Similarly, the value of the property constituting the subject of a trust at the time the trust is created is its capital. Income received by a decedent before his death is capital when received by the estate.[43]

[40] Revenue Act of 1921, § 213 (b) 1; Revenue Act of 1918, § 213 (b) 1.

[41] O. D. 755, T. B. 51-20-1355.

[42] In the case of estates of deceased persons the appraised value of the property *at the time of death* (not the date of distribution of the assets) constitutes the corpus. In the case of estates created by trust instruments the value of the property constituting the subject of the trust at the time the trust is created constitutes the corpus. (O. 1012, T. B. 12-20-792.) But see Chapter 17 as to gifts made after December 31, 1920.

[43] Telegram from treasury department dated February 3, 1917; I. T. S. 1921, ¶ 697; Reg. 45, Art. 343. A loss can not be claimed for a decedent covering the taxable period to the date of his death where the cost of securities, or their fair market value as at March 1, 1913, if acquired prior thereto, is in excess of the value established by appraisal for the purposes of administering the estate, except in the case of a decedent who was a

Gross Income of Estates and Trusts. The gross income of an estate or trust embraces income from all sources, as in the case of individuals.[44] In general, this corpus may produce income in two ways: (1) by investment of the corpus producing income in the form of interest, rents, or other return on capital, and (2) by profit derived from a sale or exchange of the corpus. Both these forms of increase of the corpus of an estate constitute taxable income to the estate. The rules laid down by the courts with respect to the distinction between income and capital in cases involving the respective rights of life-tenant and remainderman do not necessarily apply under the provisions of the income tax law, so far as assessing the tax is concerned.[45] Thus, extraordinary dividends received by an estate are held to be income to the same extent as if received by an individual, although a part of the surplus or undivided profits from which the dividends are declared may have been earned by the corporation prior to the creation of the estate. As an intestate's real estate does not pass to his administrator, upon a sale by the heirs, whether before or after settlement of the estate, each heir is taxed individually on any profit derived.[46] The income of a revocable trust must be included in the gross income of the grantor.[47] Where during the period of administration an executor converts the estate in his possession into money for the purpose of settling the estate and closing the administration, the gain or loss on the sale of such property is determined by deducting from the selling price (or vice versa) the appraised value of the property at the time of the death of the decedent or, if the estate was created prior to March 1, 1913, the fair market price or value on that date.[48] If the corpus of an estate or trust is delivered in kind to beneficiaries no income is realized by the

dealer in securities and regularly inventoried his securities. The executor should not make returns of book gains or losses, either up to the date of death or on transfer of the property to the legatee or to a trustee under the will, or from one trustee to a succeeding trustee, the appraised value remaining as the basis for computing all subsequent realizations of losses or gains in cash. (O. D. 219, T. B. 11-19-383.) No taxable income or deductible loss results from the passage of property to the executor or administrator on the death of the decedent, even though such property has appreciated or depreciated in value since the decedent acquired it. (O. D. 731, T. B. 46-20-1306.)

44 Revenue Act of 1921, § 219; Revenue Act of 1918, § 219.

45 See Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904.

46 Reg. 45, Art. 342.

47 Reg. 45, Art. 341.

48 Reg. 45, Art. 343. See, however, Ch. 17.

estate or trust, although the value of the property when delivered may be greater than its appraised value at the time of its transfer to the estate or trust.[49] If securities held in trust and forming the corpus of a trust estate are sold and the selling price exceeds their value at the time the trust is created, such excess constitutes taxable income to the estate, even though under the terms of the trust the income from the securities is payable to individual beneficiaries.[50] An executor who pays to another, as agent, a commission upon the sale of property belonging to the estate may deduct from the selling price the amount so paid in determining the gain or loss. An executor who retains as his commission a portion of the amount received by him from the sale of property belonging to the estate may not deduct the amount in the return for the estate, since any service performed by him in that connection is deemed to be a part of his duties as executor. Such a commission, however, should be included in the gross income reported in the executor's personal return for the year in which received.[51] Where the trustee of assets of an oil company sells oil or gas wells and the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the trustee, the limitation upon the surtax attributable to such sale is applicable.[52] Amounts paid by an executor of an estate out of his personal funds in discharge of obligations of the estate, such amounts being credited against the executor's liability for interest to the estate, are nevertheless income to the estate to the extent that they represent interest accrued since the death of the testator on obligations of the executor to the estate.[53]

Amount Received in Settlement of Claims. Where a corporation turns over a real estate mortgage to the executors of an estate in process of administration in part payment of a claim held against it by the estate, the executors accepting such mortgage at its face value, no part of such mortgage will constitute taxable income to the estate, unless the face value is greater than the fair market value of the decedent's claim against the company at the date of death.[54] Where a corporation in liquidation turned over its assets to the executor of an estate to which it was indebted and which owned all of its outstanding

[49] See Reg. 45, Art. 343.
[50] O. D. 129, T. B. 3-19-198.
[51] O. D. 632, T. B. 33-20-1135.
[52] O. D. 194, T. B. 9-19-337. See Chapter 2.
[53] O. D. 51, T. B. 1-19-70.
[54] O. D. 1084, T. B. 44-21-1896.

capital stock, any excess in the value of the assets so received over the indebtedness of the corporation to the estate plus the value of the stock at the time of the owner's death constitutes profit in the hands of the executor of the estate.[55]

INCOME CONSTRUCTIVELY RECEIVED BY DECEDENT PRIOR TO DEATH. Where dividends are declared on stock and interest accrues on bonds and mortgages during the lifetime of a decedent keeping his accounts upon a cash receipt and disbursement basis, but such dividends and interest are not paid until after his death, the dividends are income of the decedent when credited to or set apart for him, although not collected prior to his death. If the interest is upon matured coupons not cashed, but nevertheless available to the decedent prior to his death, it is constructively received when made available. If the interest is mortgage interest, it should be included in the decedent's gross income for the year in which it becomes due and payable.[56] It follows that such dividend and interest income, having been constructively received by the decedent during his lifetime, should be treated as capital of the estate, and will not be taxable in the hands of his estate. Interest accrued on bonds owned by an individual at the date of his death should be included in the return filed for the decedent by the executor or administrator, if the books of the decedent were kept on an accrual basis; if the books were kept on the basis of actual receipts and disbursements, only the amount of interest on coupons falling due prior to decedent's death should be included. Interest accruing or falling due subsequent to the decedent's death should be reported in the return of the estate.[57]

PROCEEDS OF LIFE INSURANCE POLICIES. The proceeds of life insurance policies paid to an estate upon the death of the insured are exempt from income tax under the present law as well as under the 1918 Law.[58]

[55] A. R. R. 67, T. B. 17-20-877.

[56] Letter from treasury department dated May 31, 1919; I. T. S. 1919, ¶ 3407.

[57] O. D. 454, T. B. 15-20-851.

[58] Revenue Act of 1921, § 213 (b) (1); Revenue Act of 1918, § 213 (b) (1). Under the 1916 Law the proceeds of life insurance policies were exempt only if paid to *individual beneficiaries* (Revenue Act of 1916, § 4; Act of October 3, 1913, B). It was first held under the 1916 Law that the proceeds of life insurance policies payable to the estate of a decedent, when received by an executor or administrator, were, in the amount by which they exceeded the premium or premiums paid by the decedent, income of the estate, to be accounted for by the executor or administrator. (Reg. 33 Rev., Art. 29.) It has since been ruled that proceeds of life insurance policies

INSTALLMENT SALES OF REAL PROPERTY. In February, 1919, an individual contracted for the sale of certain land, receiving $1,000 in cash, the balance of $11,000 to be paid in April, 1919. The vendor died before April, 1919, and the contract was not completed until September of that year when the deed was passed and possession taken by the purchaser. The treasury department has held that the decedent did not receive taxable income from the transaction inasmuch as the contract was not consummated during his life and since the $1,000 received by him prior to his death was mere earnest money to bind the contract. Neither was any taxable gain realized by the estate because of the transaction. Although the legal title to the land vested in the executor for purposes of administration, the substantial thing that went to the executor was the right under the contract to the unpaid balance of the purchase price in trust for the devisees. Under the law the basis for determining the gain or loss upon the sale or conversion of property acquired by bequest, devise or descent, is the value of the property at the death of the testator.[59] In this case the value of the right or contract and not the value of the land should be considered. As the right or contract was in this case valued for federal estate tax purposes at $11,000, which was the amount received by the estate, there could be no gain or loss to the estate.[60] This ruling modifies a previous decision of the department, where under somewhat similar circumstances it was held that the executor should report as income to the estate the difference between the fair market value of the property at the date of death and the total price received for the property.[61]

INCOME BEQUEATHED TO A GOVERNMENTAL AGENCY OF A STATE. Where executors under a will hold property specifically bequeathed to a university, state owned, controlled and operated in every sense, and conducted by officers appointed in accordance with the state Constitution, supported by state funds and all the property of which is vested in the state, and the other assets of the decedent's estate are sufficient to pay all debts, income received by the executors during the period of adminis-

payable to the estate of a decedent are not to be accounted for as income of the estate by the executor or administrator under the provisions of § 2 (b), Act of September 8, 1916. (T. D. 3190, T. B. 29-21-1732.)

[59] If the property was acquired prior to March 1, 1913, see the rules set forth in Chapter 17. The present law contains a new provision respecting profits from the sale of property acquired as a gift after December 31, 1920. See Chapter 17.

[60] O. D. 907, T. B. 7-21-1448.

[61] See O. D. 631, T. B. 33-20-1134.

tration from such property is not taxable in the hands of the executors. The education of the citizens of a state, when conducted by the state or by its subdivisions or agencies, is considered to be one of the public governmental functions of the state.[62]

ACCUMULATIONS FOR CHARITABLE PURPOSES. Where a testator by will bequeaths and devises his whole estate to his executors in trust to invest and keep invested and to pay annuities to certain beneficiaries, the corpus of the estate, together with accumulated income to be paid to a designated charity after the coming of age of one beneficiary and the death of the survivor of the others, it has been argued that the income of the trust estate is taxable, notwithstanding the fact that it ultimately goes to charity. This argument was based upon the theory that while the estate might be large and the income therefrom many times the sum required to meet the annuities, there was no legal certainty that anything would go to the charity. The court held, on the contrary, that such income was exempt from tax on two grounds: (1) That one part of the income was exempt because of the exemption in favor of charity, and the other part because it was below the taxable limit, such parts taking in the whole income; (2) that the income was not the income of the estate but of the parties to whom it was given, the legal representatives of the testator being nothing more than the reservoir and conduit pipe through which the income reached the beneficiaries.[63]

It has been held by the treasury department, on the other hand, that income from the corpus of an estate which at some uncertain date in the future will, together with the accumulation of income of a certain character, be paid over to exempt corporations is taxable in the hands of the trustee, there being no exemption in the law to trustees who are to hold income for future distribution to exempt corporations.[64]

[62] S. 1374, T. B. 18-20-896. This conclusion was strengthened by the fact that under the laws of the state in question title to the property specifically devised or bequeathed passed by will. The title to the stocks bequeathed, therefore, vested immediately upon the death of the testator in the state university and under such circumstances a tax directed against the income from such property would be a tax upon income from property the title to which has vested in a state university. The ruling was made under the 1916 Law, as amended, but it would be equally applicable under the present law.

[63] Stockton v. Lederer, 262 Fed. 173, affirmed 266 Fed. 676.

[64] O. 1012, T. B. 12-20-792.

Where under the terms of a will or trust deed income is to be paid to or permanently set aside for a charitable or exempt organization, such income is not deductible by the estate or trust where the exempt organization has received its charter, but has not been completely organized or has not begun to operate sufficiently to establish its exemption.[65]

In another case a testator gave property to a trust company to be held in trust for his wife and daughter for the period of their lives, the income accruing to be divided equally between them. It was provided that upon the death of the wife she might appoint a certain portion of the estate by her will and a similar provision was made in the case of the daughter. The principal remaining at the termination of the trust was directed to be paid over to certain charitable and educational corporations. In case the corpus of the estate remaining upon the death of the life beneficiaries was not in excess of the amount which might be appointed by the life beneficiaries in their respective wills the charitable and educational corporations would receive no part thereof, since it would go to the persons designated by the wife and daughter under the power of appointment given to them by the will of the testator. In 1918, prior to the termination of the trust, a certain sum was received by the trustee from the sale of subscription rights on stock, which sum was added to the corpus of the estate. Upon the assumption that the subscription rights on stock which were sold were granted directly to the trust company as trustee, it was held that the entire proceeds from their sale, which was added to the corpus of the estate for future distribution, must be reported by the trustee in a return for the estate on Form 1040 (Revised), together with all other income so accumulated during the taxable year.[66]

An individual died in August, 1916, and by his will devised to his wife certain specific property together with one-half of all his remaining estate. After making several other specific bequests he then directed that all the rest and residue of his estate should be given to his wife. With respect to the one-half interest given and the residuary estate left to her, the will specifically provided that these properties were given to his wife, "to have and to hold the same to her for and during her natural life, with full power of disposing of the same by deed, will, or other mode of transfer, my intention being not to vest in my said wife an absolute estate or an estate in fee simple in said residue of my property, but an estate for life only, with the use

65 O. D. 278, T. B. 20-19-511.

66 O. D. 507, T. B. 20-20-939.

and enjoyment thereof during her life as her needs or pleasure may require and with the power of disposing of the same as aforesaid." Another clause of the will provided that if the wife should at her death leave unused or undisposed of any portion of the property thus given, it should be transferred to certain persons and institutions named in the will. In September, 1916, the wife executed a will making certain bequests and giving the residue of her estate to certain charitable, religious and educational institutions. These institutions were unquestionably exempt organizations. In 1917, the wife executed a trust indenture by which she transferred to a corporation as trustees, all her interest and right in the estate of her husband making specific reference thereto. The trustees were to have full control of the property during her life and were to pay over to her the entire income and upon her death the whole of such trust fund then in the hands of the trustees was to be paid over, delivered and conveyed to the persons named in her will. The will was by reference made a part of the trust agreement for the purpose of providing for the distribution of the trust fund and the designation of the beneficiaries of the trust. The trust was by its own terms declared irrevocable. The funds were paid over to the trustees in accordance with the directions of the trust instrument and the trustees assumed full control. During the lifetime of the wife, the trustees paid over to her the entire income from the trust funds and returned it as her income. The wife died in July, 1918, and the former trustees held the trust property for some time before conveyance was made to the beneficiaries. It was held that the income from such property was the income of the beneficiaries and since they were exempt, was not taxable. The trustees were required to make a return on Form 1041, taking as a deduction all amounts paid to or permanently set aside during the taxable year for the named exempt institutions. It was the opinion of the treasury department that the husband bequeathed to his wife a life estate in the property coupled with the power of disposition by deed, will, or other mode of transfer. The wife's will, since it made no reference whatever either to the property or to the power granted in connection therewith, could not be considered an execution of the power of disposition. The trust instrument executed by the wife referred specifically to the property bequeathed to her by her husband and although it did not specifically refer to the power, was an exercise of the power of disposition granted. The trust instrument was by its own terms declared irrevocable. Even if the will was revoked (which it was not) and became

ineffective as a will, it was incorporated and made a part of the trust disposition by reference, for the purpose of providing for the distribution of the trust fund and the designation of the beneficiaries. When the precise nature of a trust and the particular persons who are to take and their interests can be ascertained, the trust will be executed, and it was concluded, therefore, that the trust instrument was irrevocable and effective to convey the property according to its terms. The effect of the delivery of the trust property to the trustees was to vest title in the beneficiaries immediately and they were, therefore, entitled immediately, upon the death of the wife, to the trust property and it at no time constituted a part of the wife's estate.[67]

LIBERTY BOND EXEMPTION IN CASE OF ESTATES AND TRUSTS. When income is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries periodically, each beneficiary is regarded as the owner of a proportionate part of the bonds held in trust and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. In such a case a subscription by a trustee for bonds of the Fourth Liberty Loan, or notes of the Victory Liberty Loan, constitutes each beneficiary existing at the time of such subscription an original subscriber for his proportionate part of such bonds or notes, as the case may be, and entitles such beneficiary to the appropriate collateral exemption of interest on bonds of previous issues, whether owned by such beneficiary or by the trustee, as if the beneficiary had himself originally subscribed for such proportionate part of the bonds or notes; and a subscription by such beneficiary for bonds of the Fourth Liberty Loan or notes of the Victory Liberty Loan, as the case may be, entitles him to the appropriate collateral exemption of interest on bonds of previous issues held by the trustee. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trustee is regarded as the owner of all the bonds held in trust and the trust is entitled to exemption on account of such ownership. In such a case a subscription by a trustee constitutes the trustee as such the original subscriber and entitles the trust, on account of such subscription, to the collateral exemption of interest on bonds of previous issues.[68] Where a testator died in February, 1920, and

67 A. R. R. 551, T. B. 24-21-1688.

68 Reg. 45, Art. 81. The Liberty bond tax exemptions are now consolidated in § 1328 of the Revenue Act of 1921. This section as of January 1, 1921, abolishes the exemptions founded upon original subscription to the Fourth Liberty Loan and the Victory Liberty Loan.

at the date of his death owned certain Fourth Liberty Loan bonds for which he was the original subscriber, and by his will his widow, who is the residuary legatee of his estate is entitled to the bonds, it was held that neither the estate of the testator nor the widow is entitled to the collateral exemption provided by the supplement to the Second Liberty Bond Act, because neither the estate nor the widow was the original subscriber to the Fourth Liberty Loan bonds owned by the decedent at the date of his death. It has been held, also, that the collateral exemption cannot be properly claimed in the return of the decedent for the period from January 1, 1920, to the date of his death, because the bonds having passed to his estate at his death could not in fact be owned by him on the date such return was filed with the collector.[69]

Deductions Allowed to Estates and Trusts. In computing the net income of trust estates the law allows the same deductions as are allowed to individuals with the exception indicated in the next following paragraph.[70] The treasury department, however, has made several special rulings with respect to the deductions which may be claimed by fiduciaries against the income of estates or trusts and these rulings are given in the succeeding paragraphs.

CONTRIBUTIONS TO CHARITIES. In lieu of the deduction authorized in the case of citizens or residents for charitable contributions, trust estates are allowed to deduct without limitation any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for the use of: (a) The United States, any state, territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (b) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the women's auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (c) the special fund for vocational

[69] O. D. 742, T. B. 49-20-1333. See footnote 68.

[70] Revenue Act of 1921, § 219 (b); Revenue Act of 1918, § 219 (b); Reg. 45, Art. 341.

rehabilitation.[71] No deduction may be taken for an amount of income retained or permanently set aside for the benefit of a religious, charitable, scientific or educational corporation where such corporation is not fully in existence at the time the income is so retained or set aside.[72]

Ordinary and Necessary Expenses. The ordinary and necessary expenses of carrying on a business conducted by a fiduciary, including a reasonable allowance for salaries, rentals, repairs to business properties, etc., have been held to be properly deductible, since they are expenses which reduce the income accruing to the beneficiaries.[73] A distinction has been made between expenses properly chargeable against the corpus of an estate at the time of its creation, and expenses incident to administration arising from the nature of the properties of an estate and the details of its business management. Thus, court costs, attorneys' fees, executors' commissions, etc., have been held generally to be expenses that reduce the corpus of the estate in the fiduciary's hands and not expenses which directly reduce the income accruing to the beneficiaries. For this reason such expenses are ordinarily not a proper deduction.[74]

In a recent case before the department the question arose as to whether various expenses were deductible as business expenses or must be classed as expenses of administration. A testatrix left an estate consisting principally of corporate securities. After numerous specific bequests, the residuary estate was given to executors and trustees with instructions that for a period of two years after the death of the testatrix they should collect the rents, income and profits therefrom, applying a part thereof to the payment of the debts, taxes and charges, governmental or otherwise, payable by or out of the estate, and applying as much as they should deem advisable for the support, education and maintenance of a certain beneficiary. At the end of the two-year period, the residuary estate was to be divided into two parts and the income therefrom paid to two named beneficiaries. The ordinary and necessary expenses incurred in managing the property were admittedly deductible in computing

[71] Revenue Act of 1921, § 219 (b); Revenue Act of 1918, § 219 (b); Reg. 45, Art. 341. It will be noted that the 1918 Law did not include the words "for exclusively public purposes," or "community chest, fund or foundation," or "including posts of the American Legion or the Women's Auxiliary units thereof."

[72] A. R. R. 280, T. B. 46-20-1305.

[73] Revenue Act of 1921, §§ 219 (b) and 214 (a) (1); Revenue Act of 1918, §§ 219 (b) and 214 (a) 1; O. D. 537, T. B. 23-20-988.

[74] Reg. 45, Art. 293; T. D. 2090, T. D. 2135; O. D. 537, T. B. 23-20-788.

net income, since where substantially the entire income of the taxpayer is received from investments and dealings in securities, such investments and dealings in securities constitute the carrying on of a trade or business. The difficulty arose in distinguishing between business expenses and administration expenses. In this case the executors were engaged in trade or business only to the extent that they continued the business of the decedent and only expenses incurred in continuing the business were allowable deductions. On the other hand, the ordinary duties of the executors as such are to secure the necessary processes and orders of the probate court, collect the assets of the estate, satisfy the debts of the decedent and the estate and inheritance taxes, preserve the assets of the estate until distributed, and distribute such assets to the beneficiaries, if necessary reducing them to cash for this purpose. Expenses incurred in discharging these and similar duties are clearly expenses of administration. Certain expenses, however, such as salaries of clerks and office rents, contribute both to the administration of the estate and the continuance of the business of the decedent. With regard to these expenses it was held that a segregation should be made and there should be estimated the proportion of the personal services or facilities secured by the expenditure which contributed to the administration of the estate and the proportion which contributed to the continuance of the business. It was held immaterial whether the expenses were paid from the corpus of the estate or from income. Expenses derive their character not from the funds out of which they are paid, but from the purposes for which they are incurred. The executors were allowed a commission upon cash received and paid out by them in the course of the administration. They retained this commission upon funds received by them from sales of securities and upon funds paid out by them for the purchase of securities, including investments and reinvestments as well as upon receipts and disbursements made by them in the ordinary course of administration. These fees were held to be administration or business expenses, according to the transactions for which they are allowed. The same rule was applied to attorneys' fees and fees of expert accountants paid upon itemized bills. Payments made upon unitemized bills of attorneys and accountants were treated as expenses contributing both to the administration of the estate and the continuance of the business of the decedent, and the proportional parts of such expenditures attributable to business or administration expenses, respectively, were required to be estimated. Office expenses and salaries of bookkeepers and clerks,

including executors' commissions thereon, also contributed both to the administration of the estate and the continuance of the business, and were required to be apportioned in the same manner. Expenses connected with the sale of property, including executors' commissions and attorneys' fees, were held to be expenses of administration in all cases in which the sale was made for the purpose of securing cash to satisfy legacies or to satisfy items which were themselves expenses of administration or necessary in the administration of the estate, such as court costs, estate and inheritance taxes, etc. On the other hand, when the sale was made to secure cash for the purpose of continuing the business, as for reinvestment or to satisfy business expenses or the income tax, the expenses of the sale were held to be expenses of business. When property was sold to secure cash for both administration purposes and purposes connected with the continuance of the business, the expenses of the sale were required to be allocated in the percentages in which the proceeds of the sale were used for administration and business purposes. Expenses, including executors' commissions and attorneys' fees, incurred in collecting dividends and interest, investing funds, preparing income tax returns and paying the tax, were made necessary by reason of the continuance of the business and consequently were held to be business expenses. Expenses, including executors' commissions and attorneys' fees, incurred in the preparation of the return for, and the payment of, the federal estate tax and state inheritance taxes were necessary for purposes which are within the ordinary duties of the executors as such, and were held to be administration expenses. All *ad valorem* taxes (except taxes assessed against local benefits) were held to be deductible from gross income.[75] However, the expenses of paying the taxes, including the executors' commissions thereon, might be deducted only if expended in the trade or business; they were business expenses when the property taxed was used in the trade or business, and administration expenses when the property is not so used, as where property was held for future distribution to legatees or devisees. The executors of this estate were independent executors under the Texas Laws, and after qualifying them and receiving and approving the inventory, appraisement, and list of claims, the probate court had no further jurisdiction over them. They were not required to report to the court for discharge, nor was there any date upon

[75] See Revenue Act of 1921, § 214 (a) (3); Revenue Act of 1918, § 214 (a) (3).

which they formally ceased to be executors and became trustees. However, when they completed the ordinary duties of administration, the period of administration ended, and thereafter office expenses and other expenses which during the period of administration contributed both to the administration of the estate and the continuance of the business, constituted business expenses. Executors' commissions, attorneys' fees, fees of expert accountants and salaries of bookkeepers and clerks paid by the estate, in continuing the business, were held deductible only to the extent that they were reasonable compensation.[76]

Amounts expended by an estate on account of special assessments for the maintenance or repair of streets or for sidewalk improvements levied upon property used in a trade or business, if the same is necessary in the conduct of such trade or business, constitute allowable deductions. In case any of the property of the estate is used for residential purposes by anyone beneficially interested in the estate, the amounts expended in payment of assessments levied upon such property for maintenance and repairs cannot be deducted by the estate, unless the rental value of the property is included in the gross income of the estate. Amounts expended for replacements can, under no circumstances, be claimed as a business expense; such items are investments of capital.[77]

An amount paid by the committee for a taxpayer, who has been declared mentally incompetent, in settlement of attorney's fees incurred by the taxpayer in resisting the proceedings looking to declare him incompetent, is not a necessary expense incurred in the management of the affairs of such taxpayer, but is a personal expense and therefore not deductible by the committee in computing the net income of the taxpayer.[78] Where trustees under a will hold real estate and are obliged to pay attorney's fees for services in connection with litigation brought by one claiming an interest in the property, it has been held that such fees are not deductible from the income of the trust as ordinary and necessary expenses even though the trustees are not authorized to sell any part of the property out of which to satisfy the attorney's fees or the tax imposed. Such expenses are held to

76 Sol. Op. 88, T. B. 8-21-1463.

77 O. D. 613, T. B. 31-20-1102. If such replacements, however, are used in connection with the business of the estate, a reasonable amount may be claimed for exhaustion, wear and tear of the property, including obsolescence.

78 O. D. 603, T. B. 30-20-1089.

be a part of the cost of the property and chargeable against the corpus of the estate.[79]

EXECUTORS' COMMISSIONS. If under the laws of the state, the terms of the will appointing an executor, or the decree of a court having jurisdiction of an estate, executors' commissions are deductible from the corpus of the estate, it has been held that they should not be deducted by the fiduciary, but if they are to be deducted from the income of the estate distributable among the beneficiaries they have been held to be deductible as a legitimate and necessary expense.[80]

STATUTORY ALLOWANCE TO WIDOW. A statutory allowance paid to a widow from the corpus of an estate is not deductible from gross income.[81] Since the law provides that "in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary," it has been held that where an executor of an estate in process of administration paid, under an order of the probate court, a monthly allowance to the widow of the testator, the court order providing that the amount should be payable out of the personal property and the income of the real estate, and the income from the personal property being more than sufficient to pay the allowance, such payment may be claimed as a deduction in the return to be filed by the executor the amounts being "properly" paid. The widow should include such amounts in her individual return.[82]

INTEREST. Where interest has accrued on notes of a decedent and been deducted from the estate in determining the amount of the gross estate for estate tax purposes it has been held that such interest, where paid by the administrator, is deductible from the income of the estate, unless the decedent kept his books on some basis other than that of actual receipts and disbursements. Only the accrued interest on outstanding obligations may be deducted, and where interest upon an old note has been capitalized by giving a new note, representing the aggregate of the old note with the interest accrued, only the amount of interest accrued upon the new note can be deducted, the new note representing payment of both principal and interest of the old.[83]

79 A. R. R. 284, T. B. 42-20-1248.

80 Letter from treasury department dated March 2, 1915; I. T. S. 1919, ¶ 1255. See also the paragraph "Business Expenses," supra.

81 Reg. 45, Art. 341.

82 O. D. 829, T. B. 9-21-1482.

83 A. R. R. 113, T. B. 21-20-953.

TAXES. Any tax paid by a trust estate is a proper deduction to the same extent as in the case of individuals or corporations.[84] The United States Supreme Court has recently held that the federal estate tax is deductible by an estate in determining its net taxable income for the year in which the estate tax is paid or accrues under the broad provision of the law permitting the deduction of "taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes."[85] Where property owned by an estate is sold, the amount of the stamp tax upon the deed conveying title to the property constitutes an allowable deduction in the return of the estate.[86]

LOSSES. Losses sustained during the taxable year, and not compensated for by insurance or otherwise, (a) if incurred in trade or business, (b) if incurred in any transaction entered into for profit, though not connected with the trade or business, or (c) if of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, and from theft, or losses in inventory or from rebates (under the Revenue Act of 1918) and net losses may be deducted by fiduciaries under the rules applicable to individuals.[87]

The cost of property, sold for purposes of determining loss, upon a sale or exchange thereof, is the appraised value at the time the decedent died, or the estate was created. The deductible loss should be computed in accordance with the rules discussed in another chapter.[88]

Net loss resulting from the sale of stocks, bonds, or other property owned by a trust, which would be an allowable deduction from the gross income of an individual is an allowable deduction from the gross income of a trust, whether or not the income of such trust is "to be distributed to the beneficiaries periodically, whether or not at regular intervals," and whether or not there is any requirement in the instrument creating the trust, a decree of court, or a general law, that the principal of the trust shall be kept intact at the expense of income as against such loss. Such a deduction is not allowable as against the current or future gross income of the present beneficiaries, or of

84 See Chapter 24 and the paragraph "Business Expenses," supra.

85 U. S. v. Woodward, 65 L. ed. 728. This case reverses Prentiss v. Eisner, 267 Fed. 16, and the previous rulings of the treasury department to the contrary. See Op. A. G. 1, T. B. 16-20-875.

86 O. D. 632, T. B. 53-20-1135.

87 See Chapter 25.

88 See Chapter 17. See also Chapter 25.

those who will receive the property at the termination of the trust. The beneficiary is not required to include in his personal return as a part of "his distributive share whether distributed or not, in the net income of the * * * trust for the taxable year" any part of the amounts allowed to the trust as a whole as a deduction for loss resulting from the sale of the property.[89]

WORTHLESS DEBTS. Worthless debts may be deducted to the same extent as in the case of individuals. Where a decedent was coindorser on the note of a corporation in process of liquidation at the time of his death, and his share of the liability was not known at the time of his death, but was determined at the end of 1918 and paid by the administrator in the early part of 1919, the payment was held deductible in the administrator's return in the year in which the liability was paid and charged off on the administrator's books, provided all the circumstances indicated the debt to be worthless and uncollectible, and that legal action to enforce payment would in all probability not have resulted in the satisfaction of execution on a judgment. The same decedent was not permitted to deduct the difference between the appraised value of a subrogated claim against a company whose past due note decedent had been obliged to pay as indorser and the amount paid to the bank payee. The theory of this decision was that the transaction was not a closed and completed one. So long as the claim against the company was not disposed of by the administrator, the exact amount of the loss, if any, could not be definitely determined, and, therefore, could not be claimed as a deduction.[90] The Revenue Act of 1921 contains a new provision to the effect that when satisfied that a debt is recoverable only in part, the commissioner may allow such debt to be charged off in part.[91]

DEPRECIATION. An individual who receives income from a trust estate is not permitted to claim a deduction in his personal return for any depreciation sustained during the year on real estate or other assets of the estate. It is permissible, however, for the fiduciary in ascertaining the net income of the estate or trust for which he acts to deduct a proper amount for the depreciation sustained during the taxable year, whether or not the

89 Letter from treasury department dated October 13, 1919; I. T. S. 1919, ¶ 3626. Where the income of an estate is to be distributed periodically and the trustees sell part of the principal or corpus of the estate at a loss. the beneficiaries are not allowed to deduct any part of the loss in their returns. (O. D. 156, T. B. 5-19-255.)

90 O. D. 556, T. B. 25-20-1017.

91 Revenue Act of 1921, § 214 (a) (7). See Chapter 25.

terms of the will or agreement creating same or a decree of court provides for the taking care of depreciation which may be sustained on the property held in trust.[92] Replacements to streets and sidewalks used in connection with the business of an estate are not deductible as business expense, but will constitute the subject of an annual allowance for depreciation.[93]

Net Income of Estates or Trusts. The gross income minus the deductions permitted to an estate or trust, as enumerated above, constitutes its net income. If such net income is (1) received by estates of deceased persons during the period of administration or settlement and not properly paid or credited to any legatee, heir, or other beneficiary during that period, (2) accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, or (3) held for future distribution under the terms of the will or trust, it is to be treated as taxable income of the estate or trust on which the fiduciary must pay the tax from the funds of the estate or trust.[94] When the income upon which the fiduciary has so paid the tax is later distributed among the beneficiaries, it is a distribution of capital and no tax is at that time required to be paid by the beneficiary with respect thereto.[95] If, on the other hand, the net income is (4) to be distributed to the beneficiaries periodically, whether or not at regular intervals, or (5) is collected by the guardian of an infant, to be held or distributed as the court may direct, or (6) is properly paid or credited to any legatee, heir, or other beneficiary during the period of administration of an estate, the amount of the distributable share of each beneficiary is assessed to the beneficiary.[96] In such cases the fiduciary may be responsible for the payment of the tax, as, for instance, when the beneficiary is a minor or a nonresident alien, but the tax is still the tax of the beneficiary, and the fiduciary, in paying such tax, does not act for the estate or trust. Under the 1921 Law, in the case of an estate or trust the income of which consists partly of the class included in (1), (2) and (3) above and partly of the class included in (4), (5) and (6), the net income of the estate or trust is required to be computed by the fiduciary as in the case of (1), (2) and (3) and the tax must be paid by the fiduciary,

[92] Letter to treasury department dated October 6, 1919; I. T. S. 1919, ¶ 3632.

[93] O. D. 613, T. B. 31-20-1102.

[94] Revenue Act of 1921, § 219; Revenue Act of 1918, § 219.

[95] Reg. 45, Art. 344; Reg. 33 Rev., Art. 29.

[96] Revenue Act of 1921, § 219; Revenue Act of 1918, § 219.

but there is, in such cases, allowed as an additional deduction the income of the class included in (4), (5) and (6). Such income will be included in the returns of the beneficiaries.[97]

DECEDENT'S ESTATE DURING ADMINISTRATION. During the period of administration it is the duty of the administrator or executor to make return and pay whatever tax may be due on income received by the estate of a deceased person.[98] Income of an estate during the period of administration not paid or credited to the beneficiaries is taxable to the estate, even though the beneficiaries are as a matter of law entitled to be paid or credited with such income during the year.[99] An executor or administrator of an estate in process of administration may not, at his option, in rendering the return, Form 1040, for the estate, either claim as a deduction the amount of income properly paid or credited during the year to any heir, legatee, or other beneficiary, or compute the net income without the benefit of such deduction and pay the entire tax himself.[100]

In a case ruled upon by the treasury department an individual died in 1917, his widow qualifying as administratrix in 1918. The entire estate was left to the widow, with the exception of a legacy which was paid in 1918, during which year all debts, taxes and costs of administration were paid in full, the widow as sole beneficiary reducing whatever remained to her possession as her personal estate. Upon making final report and settlement

[97] Revenue Act of 1921, § 219 (e). For the procedure in such cases under the 1918 Law, see p. 140.

[98] O. D. 598, T. B. 29-20-1082.

[99] T. B. R. 47, T. B. 16-19-46. The rule in New York that one who receives a bequest of the income of a specified sum, the property of the decedent being income producing at the time of his death, is entitled to such income from the date of death. Re Stanfield's Estate, 135 N. Y. 292, 31 N. E. 1013 has no application to interests arising under a will creating a trust of the residuary estate, and directing the payment of the income of certain portions thereof to specified individuals. The trust being created only at the expiration of administration, the right to the income of the trust fund accrues only at that time; and consequently, under the Revenue Act of 1916, no part of it is taxable to the individual beneficiary during the period of administration, but the whole of it is taxable to the estate as an entity. (Revenue Act of 1916, § 2 (b).) The result is the same where the will creates a right in the legatee to income from the date of the death, since such income is not payable until the completion of administration, and until that time the property producing the income is part of the estate in process of administration. Under the Revenue Acts of 1918 and 1921, however, the estate is entitled to deduct income properly paid or credited to legatees during the period of administration, and such income is taxable to the beneficiary. (L. O. 1051, T. B. 38-20-1206, revoking S. M. 783.)

[100] O. D. 967, T. B. 27-21-1714.

in 1921, a court order was issued discharging the widow from liability as administratrix. It was held that inasmuch as the estate of the testator was in process of administration until 1921, the widow as administratrix is required to file a return for the estate for the period from the date of the testator's death to December 31, 1917, for each of the calendar years 1918, 1919 and 1920, and for the period January 1, 1921, to the date of her discharge, during any of which periods the net income of the estate amounted to $1,000 or more. The return for the first period should be on Form 1040 or 1040a, and the administratrix was required to pay the tax upon the basis of such returns. If the income of the estate for any of the other periods in question was $1,000 or more, as computed without deducting the amount paid or credited to the beneficiary, returns covering such periods were also required to be made on Form 1040 or 1040a, as the case might be. The returns were required to be accompanied by a statement showing that during each period the entire net income was paid or credited to the widow as sole beneficiary.[101] In another case, by a certain article of his will, a testator created a trust in favor of his wife, directing that one year after her death a certain part of the principal of the trust estate should be paid to her heirs, and that the remainder of such principal should revert to and become a part of his residuary estate. In accordance with the terms of the trust, after the death of the widow and after making certain payments, the trustees during 1920 paid over to the husband's administrators all of the property remaining in their hands and the administrators in their turn distributed to the beneficiaries under the will all of the property of the estate which they held, including the property received from the trustees. This property so paid over included certain income received by the trustees during 1920. With regard to the distributions made by the administrators, all amounts so distributed were held deductible in the final return of the administrators to be filed for the estate for the period from January 1, 1920, to the date of settlement in 1920. As under the terms of the will of the husband the trustees were required to distribute at the termination of the trust the entire property of the estate, including the net income received by them, the income was properly distributable and the trustees were not required to file a return on Form 1040 or 1040a for the year in which such distribution was made. A return on Form 1041 was required to be filed, however, showing the gross income of the trust for such year and the deductions

[101] O. D. 926, T. B. 21-21-1652.

claimed, as well as the amount of income paid over to the administrators and any amount of such income paid over to the heirs of the wife. If the entire net income of the estate for 1920, including income received through the trustees, was $1,000 or more, the administrators were required to file a return on Form 1040 or 1040a, claiming a deduction for the entire amount of income received during the year, either directly or through the trustees, and properly paid over or credited to the beneficiaries under the will. This applied to the final distribution made in the settlement of the estate, as well as to distributions made during the period of administration.[102]

Where the deceased owner of real estate has not in his will directed the sale of real estate or devised the same upon trust to be sold to pay debts, legacies, or for other purposes, or done such other act as to effect equitable conversion of his real estate at his death, and the personal property is sufficient to pay all the debts and legacies, the real property does not form part of the estate and the executor will not be required to make a single return for the income from the real estate and the personal estate of the decedent during the period of administration, even though the real estate was devised to a trustee.[103] The demand of the Alien Property Custodian for the interest of a beneficiary, who is an alien enemy, entitles the Alien Property Custodian to receive from the administrator or executor the net amount found to be due by the court administering the estate of the alien enemy. After the distribution and receipt by the Alien Property Custodian of the enemy's share in the estate no further tax can be required to be reported or paid by the Alien Property Custodian. However, up to the date of the distribution of the estate it is incumbent upon the administrator or executor to report and pay the income tax due on the estate, the Alien Property Custodian being concerned only with the net amount found to be due the enemy on distribution.[104]

Credits to Trust or Beneficiary. In the case of an estate or trust taxed to the fiduciary it is allowed the same credits against net income as a single person, including a personal exemption of $1,000, but no credit for dependents. In the case of an estate or trust taxed to the beneficiaries each beneficiary is allowed for the purpose of the normal tax, in addition to his individual cred-

[102] O. D. 806, T. B. 7-21-1447.

[103] S. 1229-A, T. B. 13-20-811, revoking 1229. The same ruling applies under § 2 (b) of the Revenue Act of 1916, as amended.

[104] O. D. 598, T. B. 29-20-1082.

its, his proportionate share of such dividends ordinarily allowed as a credit to individuals and of such interest not entirely exempt from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the estate or trust. Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income.[105] The undistributed net income of a trust estate under the control of a resident fiduciary and subject to the jurisdiction of a state or territory of the United States, or of the District of Columbia, is taxable in the same manner as income accruing to an unmarried resident individual, irrespective of the fact that the creator of the trust may be a nonresident alien and irrespective of the fact that the ultimate beneficiaries may be nonresident aliens. The exemption to which a single person is entitled may properly be claimed regardless of the citizenship or residence of the creator of the trust or of the beneficiaries for whom the income is retained. The income of an estate in process of administration in the courts of a state or territory of the United States or of the District of Columbia by resident fiduciaries is taxable as an entity, irrespective of the fact that the decedent may have been a nonresident individual and the beneficiaries or distributees may be nonresident aliens and the income may be, in part or whole, derived from foreign sources. The same specific exemption may properly be claimed as that to which a single person is entitled regardless of the citizenship or residence of the creator of the trust or of the beneficiaries.[106]

Credit of Tax Paid at the Source. If the trust estate is the owner of bonds on the interest of which the debtor corporation has agreed to pay any tax withheld at the source, the law requires the debtor corporation to pay for the bondholder an amount equal to 2% of the interest paid during the year. This amount is a credit against the tax to be paid on the income of the estate or trust, and should be divided proportionately among the beneficiaries and the estate according to the respective shares of the income to which each is entitled.

Credit for Taxes. The estate may be in a position to claim credit for taxes paid in foreign countries or possessions of the United States on income derived from sources in such foreign countries or possessions,[107] in which case the amount of such

[105] Revenue Act of 1921, § 219 (d); Revenue Act of 1918, § 219 (d); Reg. 45, Art. 346.

[106] A. R. M. 37, T. B. 13-20-810; O. D. 743, T. B. 49-20-1335.

[107] See Revenue Act of 1921, § 222 (a); Revenue Act of 1918, § 222 (a).

taxes is divided between the beneficiaries and the estate according to their respective shares of the income.

Distribution of Income of Trust Estates. The Revenue Act of 1921 provides that the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary upon income (1) received by estates of deceased persons during the period of administration or settlement and not paid or credited to any legatee, heir or other beneficiary during that period, (2) accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and (3) held for future distribution under the terms of a will or trust.[108] It provides also that the tax shall not be paid by the fiduciary upon income (4) to be distributed to the beneficiaries periodically, whether or not at regular intervals, (5) collected by a guardian of an infant to be held or distributed as the court may direct, and (6) properly paid or credited to any legatee, heir or other beneficiary during the period of administration or settlement of an estate.[109] For purposes of convenience income included in (1), (2), and (3) above are referred to hereinafter as "undistributed income," and the income referred to in (4), (5), and (6) above will be referred to as "distributable income" in the following discussion. The object of the law is to tax (1) the respective beneficiaries upon any income of estates or trusts which can be definitely and legally assigned to them during the year, and (2) to tax the estate or trust as an entity upon all income which cannot be definitely and legally assigned to some beneficiary. In other words, beneficiaries are taxed when their distributive shares can be definitely determined, and if their distributive shares cannot be definitely determined at the close of the year, the tax is imposed upon the estate itself.[110] A profit from the sale of property during life tenancy which is held for future distribution to remaindermen is "undistributed" income and

108 Revenue Act of 1921, § 219 (c); Revenue Act of 1918, § 219 (c).

109 Revenue Act of 1921, § 219 (d); Revenue Act of 1918, § 219 (d); Reg. 45, Arts. 342 and 345.

110 See T. D. 2231; letter from treasury department dated October 19, 1915; I. T. S. 1919, ¶ 1235; Revenue Act of 1921, § 219; Revenue Act of 1918, § 219. This distinction is illustrated by a Hawaiian case in which it was held that income tax on an annuity paid out of income derived from property held in trust is assessable against the annuitant, not the trustee; but that surplus income from property held in trust and accumulating in the hands of the trustee pursuant to the terms of the will is not taxable prior to the arrival of the time for its distribution (Wilder v. Hawaiian Trust Co., 20 Haw. 589). This surplus income is taxable against the estate as an entity under the American law.

is taxable as an entity in the hands of the trustee of the estate.[111] When a trust provides for the distribution of income "when received" the beneficiary should account for it personally, whether distributed or not. The creator of the trust is not liable for income tax with respect thereto.[112]

Distributable Income. In the case of "distributable" income the fiduciary is required to report[113] the respective amounts paid or credited to each beneficiary. In such case there is included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the trust estate, for the taxable year, or if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the trust estate is computed, then his distributive share of the net income of the trust estate for any accounting period of such trust estate ending within the fiscal or calendar year, upon the basis of which such beneficiary's net income is computed.[114] The beneficiaries are required to report "distributable income" in their personal returns and to add the same to any income they may have received from other sources in order to determine their respective tax liabilities. They are entitled to their proportionate shares of the credits for purposes of the normal tax as indicated in the preceding paragraphs. The regulations governing partnerships are generally applicable to an estate or trust which is taxed to the beneficiaries.[115] Where a taxpayer established a trust fund, the income from which by agreement is to be paid to his former wife in lieu of alimony, maintenance and support, any excess over a certain stipulated sum which it was agreed the trustee must pay to the former wife annually to be paid to the creator of the trust and in event the former wife and sons predecease the grantor the principal of the trust to revert to him, it has been held that the instrument in question created a valid trust which is irrevocable and beyond the control of the grantor, the income of which is distributable periodically and is taxable to the beneficiary.[116]

Income Not Actually Paid to Beneficiaries in Year. It will be noted that in the case of so-called "distributable income" the tax is paid by the beneficiary upon his distributable share

[111] O. D. 560, T. B. 26-20-1029.

[112] S. 961, T. B. 1-19-69.

[113] This return is made on Form No. 1041, but like the return required of partnerships, as such, it is essentially a return of information only.

[114] Revenue Act of 1921, § 219 (d); Revenue Act of 1918, § 219 (d).

[115] Reg. 45, Art. 345.

[116] O. D. 1092, T. B. 45-21-1910, overruling O. D. 399, T. B. 6-20-730.

whether or not it is actually distributed. In other words, there may be an actual or a constructive distribution of the income of an estate. When it is credited or made available to the beneficiary, it is to be accounted for by the beneficiary as if it were actually paid over to him. Where the tax on such income constructively distributed has been paid by the beneficiary, it is not again payable when at a later date the income is actually received by him.[117] Under a will a trust fund was established, the income to be distributed to the beneficiary periodically during her natural life. The trust fund was invested in two mortgages on property owned by the beneficiary and by verbal agreement it was provided that the beneficiary should pay no interest upon the mortgages and that the trustees should pay her no income from the trust. It was ruled that the fact that the trust fund was invested in a mortgage belonging to the beneficiary and that the contract was entered into by which the trustees agreed not to collect the interest due them, the beneficiary agreeing to receive no income from the trust estate, did not alter the fact that income had accrued to the credit of the estate and that the beneficiary was in constructive receipt of income from the trust. If for any taxable period the net income of the estate should be $1000 or more, including the entire amount of interest receivable upon the mortgage, the trustees would be required to render a return on Form 1041 and the beneficiary would be required to make a return of her distributable share of the income of the trust fund. She would, of course, be entitled to deduct the amount of interest payable within the year upon the mortgages on her property.[118]

Distribution of Income of Several Years. Where a decedent died in 1913, leaving a will devising a part of his estate in trust to pay the income therefrom to one beneficiary during life, and other parts to be divided among other beneficiaries, and it was impracticable for the executors to complete distribution of the estate or determine the amount of net income until 1916, at which time an account was prepared showing the net income accruing to each beneficiary during the last three months of 1913 and during the years 1914 and 1915, a large part of the accumulated income being distributed in 1916, it was held that the executors should make a fiduciary return for each of the years

[117] Reg. 45, Art. 345; Reg. 33 Rev., Art. 29; T. D. 2289; Reg. 33, Art. 75. The theory seems to be that such income is separated from the estate when it is credited to the beneficiary, the fiduciary thereafter holding it, not as fiduciary, but as agent for the beneficiary.

[118] O. D. 606, T. B. 30-20-1093.

1913, 1914, 1915, and 1916, reciting therein the respective beneficiaries and their interests and the beneficiaries could make amended returns for any of those years in which they would be taxable by reason of the amount so distributed.[119] In this case, apparently, the respective shares of the beneficiaries were known at all times, but the amount of net income of the estate was not determinable until 1916.

Undistributed Income. Where the tax has been paid on the "undistributed" income of an estate or trust by the fiduciary such income is free from tax when it is actually distributed to the beneficiaries.[120] Where under the terms of the will or deed the trustee may in his discretion distribute the income or accumu-

[119] Letter from treasury department dated March 24, 1917; I. T. S. 1918, ¶ 728.

[120] Revenue Act of 1921, § 219; Revenue Act of 1918, § 219. See also Reg. 45, Art. 344. The 1913 Law was silent as to the taxability of "undistributed" income. It was first held by the treasury department that if income was added to the corpus of the estate, under the provisions of the will or under a statute, no tax would accrue with respect thereto, but it was later held under that law that such income was taxable, on the theory that an estate could not be without a beneficiary for income tax purposes. Where the beneficiaries and their beneficial interest were known, the income was to be reported as accruing to them, and the estate itself was to be listed as a beneficiary with respect to any of its income not otherwise beneficially assigned or accounted for. (T. D. 2231.) The executor or administrator of an estate was required to make no return of the income until the settlement of the estate had reached the stage where the beneficiaries and their respective interests in the income were determinable, at which time returns should be made showing the annual accrual, a separate return being required for each tax year involved. (Letter from treasury department dated March 4, 1916; I. T. S. 1917, ¶ 576; T. D. 2289; T. D. 2231 and T. D. 1943.) In First Trust & Savings Bank v. Smietanka, 268 Fed. 230, the court held that the earliest ruling of the treasury department was the correct interpretation of the statute and that T. D. 2231 is contrary to law. The 1916 Law provided that "income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates. * * *" (§ 2 (b).) It has been indicated by the treasury department that under the 1916 Law the income received by an estate of a decedent during the period of administration or settlement was intended to be taxed as an entity whether or not any amounts were paid over to legatees, heirs, or other beneficiaries during that period, but the language of § 2 (b) of the 1916 Law seems to indicate that the law intended the tax to be imposed on the estate "except where the income is returned for the purpose of the tax by the beneficiary," and the construction generally placed upon the provisions of the 1917 Law was that the executor or administrator became liable for the tax only on the amount not paid over to a legatee or heir during the year. This point was settled by the 1918 law.

late it, the income is taxed to the trustee, irrespective of the exercise of his discretion. The imposition of the tax is not affected by the fact that an ultimate beneficiary may be a person exempt from tax.[121] In 1915 a woman died intestate, owning real property in the state of New York and leaving surviving a husband and a son of full age, who was her sole heir at law and next of kin. The property was sold at a profit in 1920 and the proceeds by consent of the father and the son were placed in a bank in a special account in the name of the husband with an agreement between the father and the son that the father was to have the income from the fund for life and that upon his death the principal was to go to the son. Under the laws of New York, where a life estate with remainder over is created in personal property, the life tenant is entitled to possession, and upon possession becomes a trustee for the remainderman. The profits from the sale of the property accrued to and constituted a part of the corpus of the trust fund in the possession of the father, of which the son was the ultimate beneficiary. It was not distributable to the son or to the father, but under the law was required to be held in the fund during the life of the father. Such profits, therefore, represented the undistributable income of a trust entity, and the father, as trustee, was required to file a return showing the profit from the sale as income of the trust and pay the tax thereon.[122]

Estates and Trusts Which Cannot Be Treated as a Unit. The Revenue Act of 1921 provides that in the case of an estate or trust the income of which consists both of distributable and undistributed income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in the same manner as in the case of undistributed income and that the tax thereon shall be paid by the fiduciary, except that there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of distributable income. In such cases the distributable income must be included in the returns of the beneficiaries.[123] The following rulings were made to provide for such cases under the 1918 Law:

121 Reg. 45, Art. 342, is applicable only under the Revenue Acts of 1918 and 1919. Where the income of a trust fund is payable only in the discretion of the trustee, such income as the trustees distributed to the beneficiaries during the years 1916 or 1917 was taxable to the recipient personally. (Revenue Act of 1916, § 2-B; S. 1088, T. B. 11-19-382.)

122 O. D. 1040, T. B. 38-21-1830.

123 Revenue Act of 1921, § 219 (e).

In the case of certain estates and trusts it is recognized that the estate or trust can not be treated as a unit for income tax purposes and may represent an aggregate of distinct interests to all of which the fiduciaries are responsible; in such cases the procedure stated in this paragraph should govern. The following are recognized as cases which can not be treated as a unit: (a) When there is income distributable periodically and also income which is to be accumulated in trust, held for future distribution, or added to the corpus; (b) when there is income distributable periodically and also income (according to the federal income tax statutes and regulations) which is not distributable periodically under state law, e. g., gains from sale of capital assets, stock dividends; (c) when there is income distributable periodically and deductions (according to federal income tax statutes and regulations) which are not deductible under state law from the distributable income, e. g., losses from the sale of capital assets, depletion, depreciation. In ascertaining whether an estate or trust comes within any one of the cases just enumerated, the provisions of the federal statutes and regulations—rather than the provisions of the will or trust and the provisions of state laws—will determine what items constitute taxable gross income or allowable deductions; the provisions of the will or trust and of state laws will determine the allocation of items of gross income or deductions; that is, to which of the different interests making up the whole such items shall be charged or allowed. In cases in which an estate or trust cannot be treated as a unit the items of gross income and deductions, as determined by the federal income tax statutes and regulations, must be scrutinized and classified in accordance with the provisions of the will or trust, or rules of local law, into two classes. The first class will include the items of gross income and deductions so determined which relate to "undistributed" income, with respect to which the estate or trust is treated as a taxable entity and upon which income the tax is paid by the fiduciary. The second class will include the items of gross income and deductions so determined which relate to the "distributable" income, the tax upon which is not paid by the fiduciary but by the beneficiary. The result will be that the beneficiary to whom income is to be distributed periodically must include in computing his net income the amount actually distributable to him (except exempt income) even though the aggregate of the distributive shares should be larger than the net income of the estate or trust computed as a unit. Any gain, profit, or income which is not periodically distributable must be included in computing

the net income of the estate or trust so that the fiduciary will pay the tax upon any excess of the net income of the estate or trust computed as a unit over the aggregate distributive shares.[124]

Under a will a trust was created for the period of the life of a certain individual, a part of the income of which was to be paid to a charitable institution and an educational institution and the remainder to the individual. At the termination of the trust the property was bequeathed to the charitable and educational institutions. A portion of the trust property was shares of stock. In 1919, the right was given to shareholders to subscribe to additional shares of this stock which right was sold by the trustee. It was held that the amount received by the trustee from the sale of the right was taxable income, the imposition of the tax not being affected by the fact that the ultimate beneficiaries might be a charitable and an educational institution; and it was further held that the trust could not be treated as a unit for income tax purposes, there being income distributable periodically and also income which was not distributable periodically under the law of the state in which the testator resided. The trustee was required to file Form 1040, returning as income the amount received from the sale of the right which was not distributable

[124] T. D. 2987, T. B. 10-20-781, revoking all previous rulings inconsistent therewith and retroactive to January 1, 1918; O. 1013, T. B. 12-20-795-6. For example, a trust is created the income of which is distributable periodically for the life of the beneficiary, the remainder over to others. The trust has the following items of income: Rent, $3,000; interest, $2,000; gain on sale of capital assets, $1,500; cash dividend, $1,000; and deductions, general expenses (all deductible from distributable income), $700; depreciation, $300; loss on sale of capital assets, $3,000. Under the terms of the trust $5,300 will be distributed to the beneficiary, viz, rent, $3,000; plus interest, $2,000; plus dividend, $1,000; less general expenses $700. The gain and loss on the sale of capital assets will be considered capital items affecting the corpus only, and the items of depreciation will not affect the amount to be distributed, there being no rule of state law or provision of the trust requiring this deduction from distributable income. In such a case the fiduciary must report on Form 1041, showing a net income for the trust of $3,500, and must show as the distributive share of the beneficiary the $5,300 to which he is entitled. The beneficiary must account for the amount actually distributable to him as income, viz. $5,300 as provided in § 219 (d) and will be entitled to a credit of $1,000 on account of the dividends in computing the normal tax, but not to any deduction on account of depreciation or capital losses. If there had been no loss on the sale of capital assets so that the net income of the estate or trust was $6,500. Form 1041 should show the distributive share of the beneficiary as $5,300, and the distributive share of the fiduciary as $1,200; and the fiduciary should file a separate return on Form 1040A, reporting $1,200 for taxation.

periodically and also Form 1041 showing the distributive shares of the beneficiaries in that portion of the trust income which was distributable periodically.[125]

Where under the terms of the will of a decedent a trust was created part of the income of which was distributable periodically to the beneficiaries and a portion of which was to be accumulated and added to the principal of the trust or held for future distribution, and during the taxable year 1920, real estate owned by the trust was sold at a loss and the return for the trust for that year showed a net loss as a result of the sale, it was held that the amount of the loss might be deducted from the gross income of the trust for the taxable year in computing the net income of the trust as a unit; but since the loss on the sale of the capital assets of the trust affected the corpus of the trust only, each beneficiary was required to include in computing his net income the amount of the income of the trust, if any, distributable to him, even though the aggregate of the distributive shares of the beneficiaries was larger than the net income of the trust computed as a unit.[126]

Receiver in Partition Proceedings. A receiver in partition proceedings was required under the 1916 law to report at the close of each year during the pendency of the partition suit, the net income collected from the property during such year, and pay the tax thereon.[127] Where an executor under a will is also receiver in partition proceedings the income accruing to him as receiver should be reported separately and not added to the income received by him as executor, if the receivership is separate and apart from the administration and settlement of the estate.

Returns by Fiduciaries. A fiduciary is responsible for making a return for the estate or trust for which he acts.[128] The return is required to state specifically the items of gross income received and the deductions and credits allowed against such gross income, the net income, and the respective amounts distributed to the respective beneficiaries or retained by the estate as undistributed income.[129] The return is prepared in the manner indicated on the form supplied by the government. No special rules

125 O. D. 808, T. B. 7-21-1449. See, however, Chapter 20 as to income from the sale of such rights.

126 O. D. 1041, T. B. 38-21-1831.

127 Letter from treasury department dated March 14, 1917; I. T. S. 1918, ¶ 1004.

128 Revenue Act of 1921, § 219 (b); Revenue Act of 1918, § 219 (b).

129 Revenue Act of 1921, § 225; Revenue Act of 1918, § 225.

are applicable to fiduciaries, except that in case of income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and in the case of income collected by a guardian of an infant to be held or distributed as the court may direct, the fiduciary is required to include in his return a statement of each beneficiary's distributive share of the net income of the estate or trust, whether or not distributed before the close of the taxable year for which the return is made.[130]

By Whom Filed. The return is filed by the fiduciary having charge of the trust estate. Fiduciaries required to make returns are subject to all the provisions of the law which apply to individuals. Under such regulations as the commissioner, with the approval of the secretary, may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides, is a sufficient compliance with the requirements of the law.[131] In case no necessity exists for the appointment of an administrator, the beneficiaries may act jointly, or may duly appoint one of their number as the agent of the estate for the purpose of filing the income tax return of the decedent. In doing so, however, the agent assumes the responsibility for making the return and incurs the liability to the specific penalties provided for in the case of the filing of erroneous, false, and fraudulent returns.[132]

Revocable Trusts. The trustee under a revocable trust is required to file a return on Form 1041, revised, showing the grantor as the beneficiary under the trust. The trustee must also file a return of information upon which should be entered the name and address of the grantor in whose return the income should be included.[133]

When a Return Is Required. Every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) or at least one of joint fiduciaries, were required, under the 1918 law, to make a return of income (a) for the individual whose income is in his charge, if the net income of such individual is $2,000 or over, if married and living with husband or wife, or is $1,000 or over in other cases, or (b) for the estate or trust for which he acts, if the net income of such estate or trust is $1,000 or over, or if any beneficiary of

130 Revenue Act of 1921, § 219 (b); Revenue Act of 1918, § 219 (b).
131 Revenue Act of 1921, § 225 (b); Revenue Act of 1918, § 225.
132 O. D. 702, T. B. 43-20-1264.
133 O. D. 621, T. B. 32-20-1116.

such estate or trust is a nonresident alien.[134] Under the 1921 Law, in the case of (a) above, a return must be made for every individual for whom he acts if such individual has a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income, and in the case of (2) above, for every estate or trust the net income of which for the taxable year is $1,000 or over and for every estate or trust of which any beneficiary is a nonresident alien.[135]

FIDUCIARIES ACTING IN MORE THAN ONE ESTATE. In the case of two or more trusts the income of which is taxable to the beneficiaries, which were created by the same person and are in charge of the same trustee, the trustee is required to make a single return on Form 1041 (revised) for all such trusts, notwithstanding that they may arise from different instruments. When, however, a trustee holds trusts created by different persons for the benefit of the same beneficiary, he is required to make a return on Form 1041 (revised) for each trust separately.[136]

WHERE FILED. The return of a fiduciary should be filed in the collection district in which the fiduciary resides or has his place of business, regardless of the residence of the beneficiaries.[137] Where an estate has two or more joint fiduciaries, the return may be filed by one of them in the district where he resides, such filing being a sufficient compliance with the law.[138]

WHEN FILED. The return must be filed on or before March 15th in each year, or on or before the fifteenth day of the third month following the close of the fiscal year of the estate or trust, accordingly as it reports upon the basis of the calendar or a fiscal year. Foreign fiduciaries must file returns on or before June 15th if they report upon the basis of the calendar year, and on or before the close of the sixth month following the close of their fiscal year.[139]

EXTENSION OF TIME. The same extension of time may be granted for filing the returns of fiduciaries as may be granted to individuals.

[134] Revenue Act of 1918, § 225; Reg. 45, Art. 421. The return in case (a) and also in case (b) if the tax is payable by the fiduciary should be made on Form 1040 (revised), except that it may be on short Form 1040-A (revised) where the net income does not exceed $5,000. The return may be made on Form 1041 (revised) in case (b) if the tax is payable by the beneficiaries.

[135] Revenue Act of 1921, § 225 (a).

[136] Reg. 45, Art. 423; T. D. 2090; T. D. 2137.

[137] Revenue Act of 1921, § 227 (b); Revenue Act of 1918, § 227 (b).

[138] Revenue Act of 1921, § 225 (b); Revenue Act of 1918, § 225.

[139] See Chapter 34.

HOW SIGNED AND SWORN TO. The law provides that the fiduciary shall make oath that he has sufficient knowledge of the affairs of the individual, trust, or estate for which he acts, to enable him to make the return and that the same is, to the best of his knowledge and belief, true and correct.[140] When the return is signed and sworn to by an individual as a fiduciary his full address is required to be stated. If the fiduciary is an organization, the return is signed and sworn to by the president, secretary or treasurer.[141]

Returns for Beneficiaries. As a general rule, the fiduciary is not required to make any return of "distributable" income, as that term is defined in a previous paragraph,[142] for and on behalf of his beneficiary.[143] If, however, the fiduciary has been legally authorized to act as agent for the beneficiary, or is an attorney-in-fact for him, he may also make and file the personal return of the beneficiary in the same manner as any other duly authorized agent.[144] If the beneficiary is unable to make his own return, or is a nonresident alien, the fiduciary is required to make the personal return for him, as indicated in the following paragraphs.

FOR MINORS OR INSANE PERSONS. A fiduciary acting as the guardian of a minor having a net income of $1,000 or $2,000 according to the marital status of such person, or a gross income of $5,000, must make a return for such minor and pay the tax, unless such minor himself makes a return or causes it to be made. A fiduciary acting as the committee of an insane person having a net income of $1,000 or $2,000, according to the marital status of such person, or a gross income of $5,000, must make a return for such incompetent and pay the tax.[145]

FOR NON-RESIDENT ALIEN BENEFICIARIES. Where a citizen or resident fiduciary has the distribution of trust income for which there is a nonresident alien beneficiary, the fiduciary must make a return for such nonresident alien and pay the tax. If there are two or more beneficiaries, the fiduciary should render a re-

140 Revenue Act of 1921, § 225 (b); Revenue Act of 1918, § 225.

141 Reg. 33, Art. 73. See instructions on Form 1041.

142 See p. 133.

143 See, however, the paragraph "Estates and Trusts Which Cannot Be Treated as an Entity," p. 137.

144 See Reg. 33, Art. 72.

145 Reg. 45, Art. 422. Form Nos. 1040 (revised) or 1040-A (revised) are used for this purpose. See O. D. 1085, T. B. 44-21-1897.

turn on Form 1041 (revised) and also a return for each nonresident alien beneficiary.[146]

It was held under the 1918 law that a fiduciary should file Form 1040 for a nonresident alien beneficiary, even though the individual's distributive share of income is derived from dividends and is less than $5,000.[147] Where two separate trusts are created for the same nonresident alien beneficiary, each trustee is required to render a personal return on Form 1040 or 1040a on behalf of the nonresident alien, and pay any and all normal tax found by such return to be due and any and all surtax, provided the income is not returned for the purpose of the tax by the beneficiary. If one of the trustees is the representative or authorized agent of the nonresident alien, he may render a complete return on Form 1040 or 1040a, combining the entire net income from both trusts and take credit on the return for any tax paid by the other fiduciary in behalf of the nonresident alien. If the nonresident alien beneficiary of the two trusts should appoint a resident agent for the purpose of filing his return and paying the tax in his behalf, it would not be necessary for the two trustees to file returns on Form 1040 or 1040a, provided they have received notice of such appointment. The fiduciaries, however, would not be relieved from liability for rendering returns as such on Form 1041.[148]

FIDUCIARY WHO IS ALSO BENEFICIARY. A fiduciary who is also the beneficiary of the trust should file a return for the estate or trust, and should also file an individual return showing his entire income derived from the estate and from all other sources.[149]

Income to Be Reported by Beneficiary. Unless the beneficiary is under some disability which requires a fiduciary to act, the beneficiary makes his own personal return and accounts for the tax upon his entire net income, including that which has been received from the estate.[150] The fiduciary is not under any duty to account for or pay the tax on amounts distributed to beneficiaries where the beneficiary is capable of making his own return and is not a nonresident alien. The beneficiary reports the income for the year in which it is received by him or credited to

[146] Reg. 45, Art. 425. Form Nos. 1040 (revised) or 1040-A (revised) are used for this purpose. See Reg. 33 Rev., Art. 29, as amended by T. D. 2988, T. B. 11-20-785; O. D. 1085, T. B. 44-21-1897.

[147] O. D. 58, T. B. 1-19-79.

[148] O. D. 572, T. B. 27-20-1042.

[149] O. D. 208, T. B. 10-19-360.

[150] See T. D. 2090. See p. 133.

him,—that is, for the year in which it is actually or constructively received. All amounts paid by fiduciaries to beneficiaries of trust estates from the income of such trust estates, whether from reserves or otherwise, are held to be distributions of income and will be treated for income tax purposes in accordance with the provisions of law and regulations applicable to income of such beneficiaries. The beneficiary will be required in the case of trust estates to account for the actual amounts distributed or credited to him.[151]

Returns of Executors and Administrators. In addition to the duties which executors and administrators have in common with other fiduciaries, they are also required to report the income of the decedent for that part of the last taxable year during which he lived; and also for the preceding taxable year, if the decedent died before the time for filing returns for such year had expired and no return had been filed by him. Thus, if a decedent died in February, 1920, without having made a return for 1919 the executor or administrator is required to file a return for 1919 and a return for the part of 1920 in which the decedent lived.[152] If the net income of the decedent, from January 1 of the year in which he died to the date of his death, was less than the sum which would have made him liable to make a return if living, no return is required by the executor or administrator.[153] The personal exemption which may be deducted from the decedent's income so reported is the full amount allowed to living persons

[151] Reg. 33 Rev., Art. 29. See Revenue Act of 1921, § 219 and Revenue Act of 1918, § 219. In a recent case (Gavit v. Irwin, 275 Fed. 643), it has been decided that there is no provision of the 1913 Law by which it can be held that the moneys received by a beneficiary under a trust fund established by the will of a decedent, no part of the capital of which inures to the benefit of such beneficiary, are taxable income. Such moneys are held to be income to the estate but not to the beneficiary. As to him they are property acquired by bequest or devise and therefore not taxable. (I. T. S. 1921, ¶ 3177.)

[152] Revenue Act of 1918, § 223. Returns seem to be required of executors or administrators in such cases on the theory that by reason of death the decedent is unable to make his own return, a return therefore being required by the "person charged with the care of the person or property of such taxpayer." See Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654; Mandell v. Pierce, 3 Cliff. 134, 16 Fed. Cas. No. 9008; Reg. 33 Rev., Arts. 4 and 14.

[153] Revenue Act of 1921, § 223; Revenue Act of 1918, § 223; Reg. 45, Art. 421. See also T. D. 2090 and Reg. 33, Art. 17.

of the same status as that of the decedent at the time of his death.[154]

TIME FOR FILING RETURN UPON DEATH OR TERMINATION OF TRUST. As soon as possible after his appointment and qualification, without waiting for the close of the taxable year, an executor or administrator should file a return of income for the decedent. Upon the completion of the administration of an estate and final accounting an executor or administrator should file a return of income of the estate for the portion of the taxable year in which the administration was closed, attaching to the return a certified copy of the order for his discharge. An ancillary administrator need make no separate return if the domiciliary administrator includes in his return the entire income of the estate. Similarly, upon the termination of any other trust the trustee should make a return without waiting for the close of the taxable year. In any such case the requirements with respect to the payment of the tax are the same as if the return were for a full taxable year closing at the end of the month during which the decedent dies or the estate is settled or the trust is terminated, as the case may be. The payment of the tax before the end of the taxable year in such circumstances does not relieve the taxpayer from liability for any additional tax which might subsequently be imposed upon income of the taxable year.[155] Where a testator died in May, 1917, and the administration of the estate was closed and the executor discharged in October, 1918, it has been held that the tax for the period from January 1, 1918, to the close of the administration of the estate must be computed and paid at the rates imposed by the Revenue Act of 1918, even though the return was filed and the tax paid before that act became law.[156] Where a taxpayer who was granted an extension of time in which to file his 1919 return, died before the expiration of such extension without rendering a return, the return was required to be filed by the executor or administrator as soon as possible after appointment or qualification and be accompanied by the amount of any tax due, together with interest at the rate of one-half of 1 per cent. per month on the amount of any deferred installments from their respective original due dates until paid.[157]

154 Revenue Act of 1921, § 216 (f). See Reg. 33 Rev., Art. 14. See Chapter 31.

155 Reg. 45, Art. 442; Reg. 33 Rev., Art. 26.

156 A. R. R. 565, T. B. 29-21-1737.

157 O. D. 681, T. B. 41-20-1234.

LIABILITY OF EXECUTORS FOR TAX. Liability for payment of the income tax attaches to the person of an executor or administrator up to and after his discharge, where prior to distribution and discharge he had notice of his tax obligations or failed to exercise due diligence in determining whether or not such obligations existed. Liability also follows the estate itself, and when, by reason of the distribution of the estate and the discharge of the executor or administrator, it appears that the collection of the tax cannot be made from the executor or administrator, the legatees or distributees must account for their proportionate share of the tax due and unpaid. The same considerations apply to other trusts.[158]

COLLECTION OF THE TAX FROM DISTRIBUTEES. In a case in which a taxpayer in October, 1919, converted all of his property into cash and distributed it to his wife and sister, so that at the time of his death in January, 1920, nothing remained to be administered or to satisfy his income tax liability, it has been held that the gift tended to defeat the intent and purpose of the income tax law, and that liability for income tax attaches to and follows the property distributed into the hands of the recipients; also that a return for 1919 should be filed on behalf of the decedent and payment of the tax assessed against the estate of the decedent should be demanded of the recipients of the gift.[159] Inasmuch as a residuary estate is the gross estate of the decedent less proper expenses and bequests of specific amounts or specific property, and the specific bequests must be paid in full after all debts and expenses are paid, even though nothing remains to constitute a residue, it follows that if an estate is distributed and no provision made for any part of such expenses or specific bequests, a proper residue is not obtained and the residuary legatee has received an amount in excess of that to which he is entitled. Therefore, where the estate of a deceased person has been settled, no provision being made for the payment of income tax, the tax assessable is properly collectible from the residuary legatee.[160]

Returns by Ancillary Executors. The ancillary executor of the estate of a nonresident alien should make returns for the estate and pay the taxes due, as agent of the foreign executor,

[158] Reg. 45, Art. 344; Reg. 33 Rev., Art. 29.
[159] O. D. 582, T. B. 28-20-1058.
[160] O. D. 722, T. B. 45-20-1295.

and file personal returns for each nonresident alien beneficiary.[161]

In a case where a decedent, a resident of New York, but at the time of her decease living in California, left property in both states, an executor being appointed in each state, it has been held that since the entire will was probated in New York and only that part pertaining to property located in California was probated in that state in conformity with its laws, the executor in California was in fact an ancillary executor and was not required to file a return for the estate, if the domiciliary executor includes in his return the entire income of the estate.[162]

Withholding at the Source Against Fiduciaries. The provisions with respect to withholding the tax at the source apply in the case of payments to fiduciaries in the same manner as in the case of payments to individuals. There is, generally speaking, no withholding at the source on payments to citizens and residents of this country and it follows that there is no withholding at the source in the case of a fiduciary who is a citizen or a resident, or has an office or place of business in this country. The one exception to this rule is the withholding of a tax equal to 2% on interest paid on obligations of corporations containing a tax-free covenant. In such cases the tax is in theory withheld, but not in actual fact, since the paying corporation assumes the burden of the tax, paying the interest in full to its bondholder. Although the fiduciary may be a corporation, in its capacity as fiduciary it is subject to the provisions of law applicable to individuals and not to corporations; hence on payments of such interest as that referred to in the preceding sentence, the paying corporation will be required to treat the corporation fiduciary as an individual and assume the burden of the 2% tax.[163]

Withholding at the Source by Fiduciaries. A fiduciary is expressly required to withhold the tax at the source in the same cases in which individuals, corporations and partnerships are required so to do; that is, the tax must be withheld at the source by a fiduciary upon all annual or periodical payments of fixed and determinable income to nonresident aliens and nonresident foreign corporations.[164]

161 O. D. 292, T. B. 23-19-547. The personal returns are filed on Forms 1040 (revised) or 1040 (a) (revised). The ancillary executor should also file a withholding return on Form 1042 (revised) accompanied by certificate 1098 (revised).

162 O. D. 584, T. B. 28-20-1060.

163 See Chapter 40.

164 See Chapter 40.

Information at the Source. Fiduciaries are expressly subject to all the provisions of the law requiring information at the source. These requirements are discussed in full in a subsequent chapter.[165] A fiduciary is required to file with his return on Form 1041, an information return on Form 1099, covering the distributable share of each beneficiary, regardless of the amount or character of the income comprising such distributable share. This is true even though the entire income of the estate consists of dividends which may be taken as a credit against the normal tax in the case of individuals or deducted by corporations.[166]

Penalties. The law provides that fiduciaries required to make returns shall be subject to all the provisions which apply to individuals.[167] Fiduciaries are liable to the same penalties, so far as they are applicable, as those which may attach to individuals. These penalties are discussed at length in another chapter.[168]

Foreign Fiduciaries. The term "foreign fiduciary" as here used means a fiduciary who neither resides in this country nor has an office or place of business here, that is, one who is not within the jurisdiction of this government. The law provides that "fiduciaries required to make returns under this act shall be subject to all the provisions of this act which apply to individuals."[169] The law implies that foreign fiduciaries shall be subject to its provisions to the same extent as nonresident alien individuals.

TRUST ESTATES. The trust estate under the control of a foreign fiduciary is subject to tax on net income derived from sources within this country. Net income from sources within this country is determined under the same rules as apply to nonresident aliens.[170] The deductions claimed by the foreign fiduciary are governed by the rules relating to fiduciaries in

165 See Chapter 39.

166 O. D. 575, T. B. 27-20-1045.

167 Revenue Act of 1921, § 225 (b); Revenue Act of 1918, § 225.

168 See Chapter 36.

169 Revenue Act of 1921, § 225 (b); Revenue Act of 1918, § 225.

170 See Chapter 4. In state ex rel. Wisconsin Trust Co. v. Widule, 164 Wis. 56, 159 N. W. 630, it was held that dividends from stocks and interest upon notes, mortgages, etc., received by a resident trustee (individual or corporation) as a gain or profit from securities constituting the trust fund, were taxable as income from sources within Wisconsin, even though the person entitled to the enjoyment and to whom they must be paid over was a nonresident and also a co-trustee and even though two of the three trustees resided without the state. The resident trustee was held to be the recipient of the income. It has also been held in Wisconsin (Bayfield Co. v. Pishon, 162 Wis. 466, 156 N. W. 463) that where income of a nonresident testamentary

general, except so far as they are limited by rules relating to the deductions allowed to nonresident aliens. The same rules applicable to domestic fiduciaries with respect to "distributed" and "undistributed" income apply to foreign fiduciaries. Nonresident alien fiduciaries of trusts subject to the jurisdiction of a foreign country are taxable on undistributed net income from sources within the United States, irrespective of the fact that the creator of the trust or estate may be either a citizen or resident of the United States or a nonresident alien and the beneficiaries may be either citizens or residents of the United States or nonresident aliens. A personal exemption allowed a single person may properly be claimed.[171] The income of estates in process of administration in the courts of a foreign country by nonresident alien fiduciaries is taxable as an entity in so far as the income received is from sources within the United States, irrespective of the fact that the decedent may have been either a nonresident alien or citizen of the United States and the beneficiaries in the distribution may be either nonresident aliens or citizens or residents of the United States. The same specific exemption as provided for above may be claimed.[172]

RETURNS OF FOREIGN FIDUCIARIES. Under the law a foreign fiduciary is required to make under oath a return for the individual, estate or trust for which he acts, stating specifically the items of the gross income received from sources within this country, and the deductions and credits allowed by the law, and the respective shares distributable to beneficiaries. The fiduciary is required to make oath that he has sufficient knowledge of the affairs of the individual, estate or trust for which he acts to enable him to make the return, and that the same is, to the best of his knowledge and belief, true and correct.[173] In making the return he should comply with the law and regulations respecting returns by nonresident aliens.

WHERE FILED. In the case of foreign fiduciaries the return should be filed with the collector at Baltimore, Maryland.[174]

trustee was derived from sources without the state, the fact that the trust was being administered by a Wisconsin court was insufficient to subject the income to tax; that it was not sufficient that "sources" be *constructively* within the state.

171 Under the 1918 Law such exemption including the credit for dependents might be claimed only provided the fiduciary was a citizen or subject of a country which, if it imposed an income tax, allowed a similar credit to citizens of the United States not residing in such country.

172 A. R. M. 37, T. B. 13-20-810.

173 Revenue Act of 1921, § 225; Revenue Act of 1918, § 225.

174 Revenue Act of 1921, § 227 (b); Revenue Act of 1918, § 227 (b).

WHEN FILED. Returns of foreign fiduciaries are filed at the same time as those of nonresident aliens.[175] The same general rules are applicable to the filing of returns by nonresident aliens and by foreign fiduciaries. The same extensions of time may be granted and the same penalties imposed for neglect or failure to file.[176]

WITHHOLDING AT THE SOURCE AGAINST FOREIGN FIDUCIARIES. The provisions with respect to withholding the tax at the source apply, in the case of payments to foreign fiduciaries, in the same manner as in the case of payments to nonresident aliens. A foreign fiduciary may not receive the benefit of the specific exemption by filing a claim therefor with the withholding agent,[177] and cannot otherwise claim exemption from withholding of the tax at the source.[178] He may claim the benefit of deductions and credits and obtain a refund of any amounts withheld in excess of the tax liability of the estate, in the same manner as is prescribed with respect to nonresident alien individuals.[179]

WITHHOLDING AT THE SOURCE BY FOREIGN FIDUCIARIES. Since a foreign fiduciary is not personally within the jurisdiction of this government, the requirements imposed upon domestic or resident fiduciaries to withhold the tax in paying income to nonresident aliens do not apply to such fiduciaries.

INFORMATION AT THE SOURCE OF FOREIGN FIDUCIARIES. A foreign fiduciary is under no duty to supply the government with information at the source as to payments made to others, except so far as information is supplied with respect to beneficiaries in the return of income.

175 Revenue Act of 1921, §§ 225 and 227 (a); Revenue Act of 1918, §§ 225 and 227 (a).

176 See Chapters 34 and 36.

177 Revenue Act of 1921, § 217; Revenue Act of 1918, § 217. This provision of the law authorizes the Commissioner to permit nonresident aliens to claim exemption at the source, but no such permission has been granted except as to alien employees. See Chapter 40.

178 Letter from treasury department dated December 28, 1916; I. T. S 1919, ¶ 546.

179 See Chapter 4.

CHAPTER 7.

FARMERS

The application of the income tax law in the case of farmers presents certain peculiar difficulties and has been the subject of particular consideration on the part of the treasury department. A number of rulings and regulations relating specifically to farms and farming have resulted.[1] These rules pertain mainly to special items of a farmer's income, the methods permitted for the computation of his gross income, and the application of the statutory deductions to the transactions usually involved in the business of farming.

Definition. The term "farm" is defined as embracing the farm in the ordinarily accepted sense and includes stock farms, dairy farms, poultry farms, fruit farms, truck farms, plantations, ranches, and all land used for farming operations; and the term "farmer" is defined as all corporations, partnerships or individuals who cultivate, operate, or manage such farms for gain or profit, either as owners or tenants.[2]

"Gentlemen Farmers." A person cultivating or operating a farm for recreation or pleasure, and not upon the basis of the recognized principles of commercial farming, the usual result of which is a loss from year to year, is not regarded as a farmer. In such cases, if the operation of a farm results in a net gain for the year, such gain must be reported as income. If, however, the expenses and losses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income; and the expenses, being regarded as personal expenses, will not be allowed as a deduction from the income derived from other sources.[3]

[1] Reg. 45, Arts. 38, 110, 145, 171, 1586; T. D. 2665, amending T. D. 2153; Reg. 33 Rev., Arts. 4 and 123.

[2] Reg. 45, Art. 38; T. D. 2665.

[3] Reg. 45, Arts. 38 and 110; Reg. 33 Rev., Art. 4. If a farmer buys a farm which is much run down, with the intention of making it a profit paying property, to do which he is obliged to expend large amounts for labor in plowing and cultivating the land, for fertilizer, lime, etc., so that for several years the expenses will greatly exceed the gross receipts, the excess of such expenses over such receipts may be claimed as a loss against other income, provided the farm continues to be operated on a strictly commercial basis. (Income Tax Primer for Farmers, Question 80.) See A. R. R. 249, T. B. 35-20-1168.

In two recent cases[4] the question arose as to whether certain taxpayers owning large farms were engaged in the business of farming. In the first case, the plaintiff owned two farms. The first farm consisted of 1300 acres—900 of woodland and 400 of cultivated land. The place was equipped with cow barns, there were 40 cows and there was evidence of it being a cattle farm. There were no profits from the farm, although there was reasonable probability that some day there would be. The plaintiff was held, in this case, to be carrying on the business of a farmer. The second farm consisted of 180 acres and only 70 were cultivated, and the testimony was that there never was a profit or reasonable expectancy thereof, that the expenses were far in excess of what legitimately would be a farm venture and that the raising of crops was more of a hobby than a business. The court sustained the finding of the jury that the plaintiff could not be said to be carrying on the business of farming with respect to this latter farm. In the second case two questions were submitted to the jury; (1) was the plaintiff engaged in carrying on the business of farming and (2) were the expenses incurred in connection with such farm necessary expenses of carrying on business. The jury answered the first question in the affirmative and the second in the negative, the only reason for this appearing to be that while they considered the plaintiff engaged in carrying on a business, they also considered the expenses to be so gross and unreasonable as not to be necessary. In the case of a second farm owned by the same plaintiff, the jury found that he was merely a gentleman farmer, running the place as a forest preserve for his own pleasure. The plaintiff also had an office in New York city, where he went to receive his mail and through which he contended he conducted his business of farming. The jury, strangely enough, found in this connection that the expenses of the office were necessary expenses.

Inventories. Farmers may change (without formal permission)[5] the basis of their returns from that of receipts and disbursements to that of an inventory basis, which necessitates the use of opening and closing inventories for the year in which the change is made. There should be included in the opening inventory all farm products (including live stock) purchased or raised which were on hand at the date of the inventory, and there must be submitted with the return for the current taxable year an adjustment sheet for 1917 and each year thereafter

[4] Fish v. Irwin and Chapin v. Irwin, U. S. Dist. Ct., No. Dist. of New York, motions to set aside the jury verdicts denied, July 29, 1921.

[5] O. D. 841, T. B. 11-21-1504.

(prior to the year in which the change is made) based on the inventory method; upon the amount of which adjustments the tax shall be assessed and paid (if any be due) at the rate of tax in effect for each respective year. Where it is impossible to render complete inventories from the beginning of the taxable year 1917, the department will accept estimates which in its opinion substantially reflect the income, on the inventory basis, for the year 1917 and thereafter; but inventories must not include real estate, buildings, permanent improvements, or any other assets subject to depreciation.[6] Adjustment of taxes for years prior to 1917, in cases in which farmers change to the inventory basis in rendering their income tax returns for the current taxable year, is not required, because in most cases records for such prior years are not available. If, however, adequate records for the years 1915 and 1916 are available, adjustments may be made for those years also.[7] Because of the difficulty of ascertaining actual cost of live stock and other farm products, farmers who render their returns upon an inventory basis may, at their option, value their inventories for the current taxable year according to the "farm-price method" of determining costs, which provides for a valuation of inventories *at market price less cost of marketing.* If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of pricing inventories from that employed in prior years, the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year (this being the same in effect as valuing the opening inventory on the new basis and crediting income with the excess valuation brought in). If such valuation of the opening inventory for the taxable year in which the change is made, results in an abnormally large income for that year, there may be submitted with the return for such taxable year, an adjustment sheet for 1917 and each year thereafter (prior to the year in which the change is made), based on the "farm-price method" of valuing inventories; upon the amount of which adjustments the tax will be assessed and paid, as provided above. Where returns have been made in which the taxable net income has been computed upon *incomplete* inventories, the abnormality must be corrected by submitting with the return for the current taxable year an adjustment sheet for 1917 and each year thereafter (prior to

[6] Reg. 45, Art. 1586.
[7] O. D. 802, T. B. 7-21-1443.

the year in which the change is made), upon which such adjustments shall be made as are necessary to bring the closing inventory for the preceding year into agreement with the opening *complete* inventory for the current taxable year; upon the amount of which adjustments the tax will be assessed and paid, as provided above.[8] The above regulations and rulings are intended to revoke all previous rulings and instructions inconsistent therewith. Where a change is made by farmers in the basis of making their returns from that of cash receipts and disbursements to that of an accrual basis with inventories, many items of gross income and deductions may be duplicated or entirely omitted as a result of the change unless an adjustment is made of the net income for the prior years, and it is the purpose of the above provisions requiring an adjustment sheet from the beginning of the taxable year 1917 to reduce any discrepancies caused by such omissions and duplications to a minimum and properly to allocate over the period from 1917 to date, the net difference in gain or loss due to changing from a cash basis to an inventory basis. It is also necessary from an administrative standpoint that a uniform procedure be followed in such cases. It is, therefore, not permissible for farmers in changing to the inventory basis of making their returns to make adjustments by calculating their net income for the current taxable year without taking as a credit the inventory of live stock, crops, and other products at the beginning of the year in accordance with the instructions on page 4 of Form 1040-F.[9] Opening and closing inventories for the years from 1917 to date are first ascertained from the best source of information available, and the gross income of each year is adjusted by adding or subtracting, as the case may be, the additional gain or loss due to the difference between the opening and closing inventory in each year. A separate adjustment sheet should be made for each year from 1917 to date, in order that the sheet for each year may be attached to the return for that particular year. The net income is then adjusted conformably, and from this information the tax on each return is recomputed by the commissioner at the rate at which the tax was originally computed.[10] Florists are not required to use inventories of growing plants for the purpose of calculating their net income for income tax purposes and should not compute the cost of goods sold during the year by using

[8] Reg. 45, Art. 1586.

[9] O. D. 939, T. B. 23-21-1671; O. D. 1105, T. B. 47-21-1928.

[10] O. D. 1105, T. B. 47-21-1928.

an inventory value of growing plants on hand at the beginning and end of the taxable year.[11]

Accounting on an Accrual Basis. Farmers keeping books are required to report their income on the cash or accrual basis, according to the method of accounting employed by them in keeping their books.[12] In the case of a farmer reporting on the accrual basis, (in which an inventory to determine profits is used) his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale should be included in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Also live stock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory.[13]

Farmers Not Keeping Books and Not Taking Inventories. All farmers not keeping books and not taking inventories must report on the basis of actual receipts and disbursements, in order that their returns may permit of audit for the purpose of verification.[14]

Income. The income of a farmer may be in cash or in kind; that is, like the income of any other individual or corporation subject to tax, it may consist of money or of a money equivalent. In general, the income of a farmer may be said to be determined according to the same principles which determine the income of other taxable individuals or corporations, but certain special rules are set forth in the following paragraphs.

[11] O. D. 995, T. B. 34-21-1774.

[12] Revenue Act of 1921, § 212; Revenue Act of 1918, § 212; T. D. 2665; T. D. 2433. This subject is discussed in Chapter 33.

[13] Reg. 45, Art. 38.

[14] T. D. 2665. See Chapter 33.

VALUE OF PRODUCTS CONSUMED BY FARMER. A farmer is not required to report as income the value of farm products consumed by himself and family.[15]

INCOME FROM RENTS RECEIVED IN KIND. Rents received in crop shares are to be reported as income for the year in which the crop shares are sold or otherwise reduced to money or a money equivalent.[16]

INCOME FROM SALE OR EXCHANGE OF ANNUAL PRODUCE. All gains, profits and income derived from the sale of annual produce, whether produced on the farm or purchased and resold by the farmer, must be reported as income for the year in which the product is actually marketed and sold, unless an inventory is used.[17] Where a farmer exchanges farm produce for merchandise, groceries, or mill products, the market value of the article or property received should be reported as income.[18] Where a farmer purchases for a certain price land together with crops growing thereon, the basis for determining gain or loss upon a subsequent sale of the crops is the difference between the cost, or if no part of the purchase price was assigned to the crops, the fair market value thereof at the time of purchase, and the selling price less cost of harvesting and marketing.[19]

INCOME FROM SALE OF LIVE STOCK. For the purpose of this discussion live stock may be divided into three classes: (1) live stock raised on the farm, (2) live stock purchased by the farmer for the purpose of resale at a later time, and (3) live stock raised or purchased for draft, breeding or dairy purposes, or any purpose other than resale. Where a farmer keeps books

[15] T. D. 2665. Under this rule a farmer may use 100 bushels of potatoes for himself and family without being subject to tax, but if he should sell the potatoes, and use the proceeds in buying other potatoes for his family, he would be taxable. The rule seems incongruous, but may be the only practicable one under the circumstances. Speaking of a somewhat similar provision of the Hawaiian law the court said in Robertson v. Pratt, 13 Haw. 590: " * * * tax laws must be practical. It would be next to impossible for everyone to keep an account and estimate the value of everything he produced and consumed."

[16] Reg. 45, Art. 38; Reg. 33 Rev., Art. 4.

[17] Reg. 45, Art. 38; T. D. 2665. The sale of crops, dairy products, eggs and fruit, falls within this rule. (See Income Tax Primer for Farmers, Question 30.)

[18] Reg. 45, Art. 38; T. D. 2665. The rulings do not cover cases where farm products are exchanged or bartered for other articles or property having no definitely ascertainable market value, as for instance, the exchange of one horse for another, and it would seem no taxable income accrues to either party in such transaction. See Chapter 14.

[19] O. D. 714, T. B. 45-20-1285.

and carries the value of his live stock in annual inventories, the total amount received on the sale of any such stock should be entered on his books as gross receipts, and the income therefrom will be reflected through the inventories.[20] Where the farmer does not keep books and take inventories, the profit or income from the sale of live stock is, generally speaking, the difference between the cost thereof and the amount received on the sale.[21] This general rule is, however, subject to several qualifications or exceptions, as follows: (a) When the live stock was owned on March 1, 1913. For the purpose of determining gain or loss from the sale or exchange of live stock owned on March 1, 1913, the basis is the cost of such live stock. But when its fair market value as of that date is in excess of its cost, the gain which is taxable is the excess of the amount realized therefor over such fair market value. Where its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No gain or loss is recognized in the case of live stock sold or exchanged (a) at more than cost, but at less than its fair market value as of March 1, 1913, or (b) at less than cost, but at more than its fair market value as of March 1, 1913.[22]

(b) When the live stock was raised on the farm. If the live stock was raised on the farm, the farmer has no purchase price to deduct and the entire selling price is income, unless the live stock was owned on March 1, 1913, in which case the rules stated in the preceding paragraph will apply. The cost of raising such stock is not deducted from the selling price, since such cost is an item of annual expense, which should be deducted from year to year, as incurred.

(c) When the live stock has been purchased. When the live stock has been purchased, the purchase price thereof should be deducted from the selling price, unless the stock was acquired before March 1, 1913, in which case the rules stated in paragraph (a) above will apply. The expense of care, feeding and marketing such stock is not deducted from the selling price, but is treated as an item of annual expense.[23] A special rule may apply in the cases referred to in this paragraph. Under a former regula-

[20] T. D. 2665. The rulings require the value of live stock raised on the farm to be carried in inventory.

[21] Reg. 45, Art. 38. Of course, if the selling price is less than the cost the result will be a loss.

[22] Revenue Act of 1918, § 202. See Reg. 45, Art. 1561, as amended by T. D. 3206, T. B. 33-21-1767. See Chapter 17.

[23] T. D. 2665.

tion of the treasury department[24] a farmer was permitted to charge to expense the cost of live stock purchased for resale. Where the cost of live stock has been charged to expense and claimed as a deduction under that regulation in any past year, the entire proceeds from the sale of such live stock must be returned as income for the reason that the farmer is not again entitled to the benefit of a deduction which he has already received.[25]

(d) Live stock used for draft, breeding or dairy purposes. Where live stock has been purchased or raised for draft, breeding or dairy purposes, and is sold, the income is ascertained in the manner indicated in the preceding paragraph, unless the farmer has claimed a deduction for the depreciation of such stock in any year.[26] In such cases the aggregate amount allowed for depreciation in preceding years must be added to the selling price in order to ascertain the taxable profit.[27] Thus, if $35 has been claimed for depreciation in each of three years on a horse purchased for $500 and sold for $550, the taxable profit will be ascertained by adding the depreciation for three years, amounting to $105, to the selling price, making a total of $655, and subtracting from such total the purchase price of $500, leaving a taxable profit of $155.

INCOME FROM SALE OF OTHER FARM PROPERTY. Income from the sale of other farm property should be reported in accordance with the general rules set forth in another chapter.[28] In every case of the sale of machinery, farm equipment, or other capital assets (which are not to be included in an inventory if one is used to determine profits) any excess over the cost thereof less the amount of depreciation theretofore sustained must be included in gross income.[29]

EXCHANGE OF FARM PROPERTY. The exchange of farm lands in all cases in which the farm land exchanged has a market value has been held, under the 1918 Law, to constitute a completed or closed transaction from which a gain or loss is realized,

24 T. D. 2153, dated February 12, 1915.

25 T. D. 2665, Income Tax Primer for Farmers, Question 30. In such cases, however, it seems the return for the year in which the stock was purchased might be amended to conform to present rulings and the return for the year in which the stock was sold prepared accordingly.

26 Reg. 45, Art. 38. See Chapter 26 for the rules regarding depreciation.

27 Reg. 45, Art. 38. The same rule applies when farm machinery is sold.

28 See Chapter 17.

29 Reg. 45, Art. 38.

30 O. D. 429, T. B. 14-20-821. See Revenue Act of 1921, § 202. See Chapter 17.

even though the land received in exchange may be of a similar kind and of similar value. A different rule would apply under the present law.[30]

Dividends from Co-operative Associations. All dividends from co-operative associations must be included in a farmer's gross income. They are not exempt from the normal tax for the reason that the association itself is not taxed upon its earnings. They simply represent additional amounts accruing to the farmer upon sales through the association. Dividends from co-operative *buying* associations are to be treated in the same manner as dividends from co-operative *selling* associations.[31]

Proceeds of Insurance. Proceeds of insurance, such as hail and fire insurance, on growing crops should be included in gross income to the amount received in cash or its equivalent for the crop injured or destroyed.[32]

Income from Other Sources. If the cost of produce, live stock or other property which has been lost or destroyed is deducted as a loss and subsequently the farmer is reimbursed in whole or in part by the state or federal authorities (e. g. where the stock has been killed to avoid the spreading of disease) or by insurance or indemnity, the amount so received as reimbursement is income.[33] This contemplates a case where the loss may have been deducted in one year and the reimbursement is received in another year. It is allowable, however, and advisable that no loss be claimed in such cases until the reimbursement has been received, as until that time the net loss is not ascertainable. When the reimbursement is received, it should then be treated the same as if it represented the selling price and the gain or loss determined according to the rules set forth in the preceding paragraphs relative to sales. If a farmer works out his road or other taxes and claims such taxes as a deduction he must also include the same amount as income, as by the work he earns sufficient to pay the taxes. If he does not claim deduction for such taxes he need not include a corresponding amount as income. All amounts received for board of persons, board and pasturage of animals, labor of men and teams, and the hire or use of machinery must be reported as income by a farmer.[34]

[31] Income Tax Primer for Farmers, Questions 49 and 50.

[32] Reg. 45, Art. 38.

[33] Reg. 33 Rev., Arts. 4 and 123.

[34] Income Tax Primer for Farmers, Question 28. These items are reported under the head of "Income From Business or Profession" on the Tax Return.

Computing Income Upon Crop Basis. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may be computed upon the crop basis; but in any such case the entire cost of producing the crop must be taken as a deduction in the year in which the gross income from the crop is realized.[35]

Deductions. The special rules in regard to the deductions permitted to farmers are set forth in the following paragraphs. In the case of statutory deductions not treated below the general rules relative to all taxpayers apply.

EXPENSE. A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools, of short life or small cost, such as hand tools, including shovels, rakes, etc., may be included. The purchase of a cultivator and mowing machine constitute improvements. They have an estimated life of more than one year and payment for them should be considered a capital expenditure. A reasonable amount of depreciation of the machines may be deducted from gross income. The same principles apply to the purchase of a threshing machine. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. An individual bequeathed to his widow, for the term of her natural life, various orange groves in Florida, a great many of the trees of which, during a severe frost, were so seriously injured that grafting, special fertilizing, etc., had to be resorted to, to restore them, in spite of which some of the trees died. The widow expended a sum of money from her personal income for the grafting and fertilizing. It has been held that the amounts

[35] Reg. 45, Art. 38.

expended are properly allowable as a deduction for the ordinary and necessary expense of business but the widow may not deduct any amount on account of loss of trees totally destroyed since while the loss tends to reduce the income of the estate, it is not a loss to the life tenant, but is a decrease in the corpus of the estate.[36] The amount expended in purchasing draft or work animals or live stock, either for resale or for breeding purposes, is regarded as an investment of capital. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs and upkeep of an automobile if used wholly in the business of farming is deductible as an expense, if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense.[37] Any payments which a farmer is compelled to make as a result of a collision between his automobile and a vehicle is an allowable deduction if the automobile was being used in connection with his business at the time of the collision. The rule is otherwise if he was riding for pleasure.[38] The cost of digging irrigation ditches is not an allowable deduction, but the cost of repairing such ditches may be deducted.

SALARIES. Amounts paid to a male employee assisting a farmer in operating the farm are an allowable deduction. A line must

[36] O. D. 554, T. B. 25-20-1014.

[37] Rev. 45, Art. 110; Income Tax Primer for Farmers, Questions 59 and 72. Under Reg. 33 Rev., Art. 4 and T. D. 2153, dated February 12, 1915, the deduction of expenses in the return *for the year* in which they were made, even though the crops and stock in connection with which they were incurred may not have been marketed during the year for which the return was rendered, was only permissible. Where under the former rulings a farmer had not deducted the cost of producing the farm products he might deduct the same from the selling price and report only the difference as income. T. D. 2665 limited such deduction to the year in which the expenditures were made. The above ruling in relation to crops which take more than a year from the time of planting to the process of gathering and disposal limits the deduction to the year in which the gross income from the crop is realized. It was formerly held that the cost of stock purchased for resale might, at the option of the farmer, be deducted as an expense, or taken into consideration upon the sale of such stock, but that money expended for stock for breeding purposes was, as now, to be regarded as capital invested and therefore not deductible, except as the stock depreciated in value. (See also Reg. 33 Rev., Arts. 4 and 123.)

[38] Income Tax Primer for Farmers, Questions 71 and 73.

be drawn as to compensation paid to a female employee who assists a farmer about the house. If her time is employed entirely in taking care of milk and cream produced for sale, in the production of butter, cheese, etc., the care of milk cans and churns, or, if a separate table is maintained for laborers employed on the farm and her services are used entirely in the preparation and serving of the meals furnished the laborers and in caring for their rooms, the compensation paid her constitutes an allowable deduction. If, however, she is employed to assist in caring for the farmer's own household, no deduction can be claimed. Salaries paid to minor children may not be claimed as a deduction.[39]

IRRIGATION COMPANY ASSESSMENTS. In California and other states, fruit growers, ranchers and farmers are shareholders in irrigation companies, which are mutual in character, and they are often assessed, in proportion to their holdings of stock, for sufficient amounts to make repairs to the irrigation system, cleaning out pipes, laterals, etc. Such assessments can be claimed as a deduction under the heading of business expenses where their purpose is merely to raise funds to keep the irrigation system in usable condition, and not to make extensions and betterments.[40]

TAXES. In general, the rules respecting the deduction of taxes by farmers are the same as the rules respecting the deducting of taxes by other individuals or corporations subject to tax, and are discussed elsewhere in this book.[41] Farmers who work out road or other taxes may deduct the amount thereof, but if they do so they must also report the same amount as income.

LOSSES. Losses incurred in the operation of farms as business enterprises are deductible from gross income. If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage will be allowed. The total loss by frost, storm, flood or fire of a prospective crop, or of a crop which has not been sold, is not a deductible loss in computing net income.[42] In the case of orchards and vineyards acquired subsequent to March 1, 1913, and later, destroyed any deduction for loss should be confined to the amounts of capital originally invested

39 Income Tax Primer for Farmers, Questions 66 and 67.

40 Income Tax Primer for Farmers, Question 70.

41 See Chapter 24.

42 The value of such a crop has never entered into gross income, and the cost of raising the same is deductible as a necessary expense. (Income Tax Primer for Farmers, Question 78.)

in the growing trees and in the new nursery stock which was totally destroyed and the amount expended from date of acquirement to date of destruction in an endeavor to bring such trees and stock to an income-producing stage, if not previously deducted as expenses, eliminating all expenditures on account of permanent improvements or on account of trees and vines the growth of which was merely retarded and not entirely destroyed.[43] A farmer engaged in raising and selling stock, cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm. If live stock has been purchased for any purpose, and afterwards dies from disease, exposure or injury, or is killed by order of the authorities of a state of the United States, the actual purchase price of such stock, less any depreciation which may have been previously claimed with respect to such perished live stock, less also any insurance or indemnity recovered, may be deducted as a loss. The actual cost of other property, less depreciation already allowed, destroyed by order of the authorities of a state or of the United States may, in like manner, be claimed as a loss; but if reimbursement is made by a state or the United States, in whole or in part, on account of stock killed or property destroyed, the amount received must be reported as income for the year in which reimbursement is made. In determining the cost of stock for the purpose of ascertaining the deductible loss there shall be taken into account only the purchase price, and not the cost of any feed, pasturage, or care which has been deducted as an expense of operation. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure.[44]

Net Losses. A farmer who in 1919 suffered a net loss may adjust his 1918 tax in accordance with the net loss provision of the Revenue Act of 1918.[45] The Revenue Act of 1921 has extended the net loss provision so that it now applies in the case of a net loss sustained in any taxable year beginning after December 31, 1920.[46]

[43] O. D. 374, T. B. 3-20-690.

[44] Reg. 45, Art. 145; Reg. 33 Rev., Arts. 4 and 123; T. D. 2665.

[45] O. D. 558, T. B. 26-20-1025. For a definition of the term "net loss" and the procedure under § 204 of the Revenue Act of 1918, see Chapter 25.

[46] See Chapter 25.

Depreciation. A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property, including live stock purchased for draft, dairy, or breeding purposes, but no claim for depreciation on live stock raised or purchased for resale will be allowed. If an inventory is not used, a reasonable allowance for depreciation may be claimed, based upon the cost and the estimated life of draft and work animals and animals kept solely for breeding purposes and not for resale.[47] An owner of an orchard which has reached an income-producing stage is entitled to deduct from gross income an annual allowance for depreciation, based upon the capital invested, which comprises the original purchase price of the trees together with the necessary expenditures incurred in bringing them to the producing age, the rate of depreciation to be determined by the average life of the trees under normal conditions.[48]

Returns of Farmers. Farmers are required to make returns of annual income or special returns with respect to withholding at the source, information at the source, and other matters in the same manner and according to the same rules as those prevailing in the case of all individuals and corporations. This subject is treated elsewhere in this book.[49] In addition to the annual return of income, farmers who either keep no records or only records of cash receipts and disbursements are required to prepare and file a "schedule of farm income and expenses" (Form 1040F), copies of which may be obtained from the local collector. Its use is optional with other farmers.[50]

Payment of Tax; Penalties. Farmers pay the tax in the same manner as other individuals and corporations.[51] They are also subject to all the penalties which may be imposed upon other individuals and corporations.[52]

47 Reg. 45, Art. 171; Reg. 33 Rev., Arts. 4 and 123. For the rule when an inventory is used, see p. 153.

48 O. 797, T. B. 1-19-52.

49 See Chapter 34.

50 Reg. 45, Art. 38.

51 See Chapter 35.

52 See Chapter 36.

CHAPTER 8.

PARTNERSHIPS

The Revenue Act of 1921, like the Revenue Act of 1918, provides[1] that individuals carrying on business in partnership shall be liable for income tax only in their individual capacity and that there shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or if his net income is computed upon the basis of a period different from the basis upon which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any annual accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.[2] The Revenue Act of 1918 contained a new provision, requiring partnerships to file returns for each taxable year.[3] The Revenue Act of 1921 is identical with the 1918 Law in its provisions regarding the taxation of partnerships. All rulings and regulations promulgated under the 1918 Law will, therefore, be authoritative under the present law.

Domestic and Foreign Partnerships. General partnerships are divided into two classes, domestic and foreign. A domestic partnership is one organized or created in the United States, includ-

[1] Revenue Act of 1921, § 218 (a); Revenue Act of 1918, § 218 (a). Partnerships as such were not taxable under the 1916 Law, the partners thereof being taxable in their individual capacity. (Revenue Act of 1916, § 8 (e); T. D. 1957.) Partnerships were expressly excepted from the tax on corporations. (Revenue Act of 1916, § 10.) In U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27, arising under the 1913 Law, the court said in part: "This law, therefore, ignores for taxing purposes the existence of a partnership. The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partner. * * * The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name."

[2] See page 187 as to rates of tax applicable where the fiscal year of a partnership falls in calendar year in which rates are changed.

[3] See Revenue Act of 1918, § 224; Revenue Act of 1921, § 224.

ing only the states, the territories of Alaska and Hawaii, and the District of Columbia, and a foreign partnership is one organized or created outside the United States as so defined. In general, the nationality or residence of members of a partnership does not affect its status.[4] A partnership created by articles entered into in San Francisco between residents of the United States and residents of China is a domestic partnership.[5]

Limited Partnerships. So-called limited partnerships of the type authorized by the statutes of New York and most of the states are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or at-

[4] The Revenue Act of 1921 contains a new provision requiring withholding at the source in the case of certain income paid to partnerships, composed in whole or in part of nonresident aliens (Revenue Act of 1921, § 221). See Chapter 40.

[5] Reg. 45, Art. 1508. According to this definition (which is practically unavoidable in view of the definitions contained in § 1 of the statute), a partnership composed entirely of citizens and residents and doing all its business here would be a "foreign" partnership if created by articles entered into in a foreign country. The intention of the parties as to the place where the principal business is to be carried on (which is best evidenced by the subsequent acts of the partnership) would seem to be a sounder basis for a distinction between domestic and foreign partnerships. Thus, a domestic partnership would be one which has its principal place of business in this country and directs all or the greater part of its business from its office or offices in this country, whether or not the partners are citizens or aliens, residents or nonresidents, and a foreign partnership would be one which has its principal place of business in a foreign country and directs all or the principal part of its business from its office outside the jurisdiction of the United States, whether or not the partners are citizens or aliens, residents or nonresidents. The 1916 Law expressly mentioned foreign partnerships in only one provision (Revenue Act of 1916, § 13 (e)) that which required the withholding of the tax on payments of income from interest upon bonds and mortgages or deeds of trust or similar obligations of domestic or other resident corporations, to nonresident alien firms and copartnerships not engaged in business or trade within the United States and not having any office or place of business therein. No definition of the term "alien partnership" was given in the law or was to be found in the regulations. The law also referred to "nonresident alien firms" and to "nonresident alien copartnerships" synonymously, and applied the terms without regard to whether or not the firm or copartnership was engaged in business or trade within the United States or had an office or place of business in this country. The term may be argued to have had reference to the status of the partners composing the firm, and in this respect it was indefinite as a firm may be composed of nonresident aliens and resident aliens or citizens.

tempted transfer of the interest of a general partner and which can not take real estate or sue in the partnership name, are so like common-law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Illinois limited partnerships are held to be partnerships. A California special partnership is a partnership. On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other states are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership is a corporation. Such a corporation may or may not be a personal service corporation.[6]

[6] Reg. 45, Art. 1505, Art. 1506 as amended by T. D. 2943. In Art. 1506 as first promulgated Virginia partnership associations, also, were held to be corporations. Under the 1909 Law it was held that a limited partnership was liable for the tax, if organized for profit and having a capital stock represented by shares, although no "certificates of stock" were issued. (Op. Atty. Gen. Feb. 14, 1910.) Limited Partnerships were first broadly and without any qualifications held to be in the same category as corporations or associations under the 1916 Law and subject to the income tax imposed on such entities. The profits of limited partnerships so reporting were treated as dividends and were not subject to the normal tax in the hands of the partners receiving them but were subject to the additional or surtaxes in the hands of such partners. (Reg. 33 Rev., Art. 62; Reg. 33, Art. 86; T. D. 2137.) A limited partnership was defined as a form of business organization created by statute in many of the United States, wherein the liability of certain special partners, who contribute a specific amount of capital, is limited to the amount so contributed, while the general partners of the same partnership are jointly and severally responsible as in ordinary partnerships. (Reg. 33 Rev., Art. 62.) It was held that a limited partnership would be classed as a quasi-corporation or association within the meaning of the law. In a letter dated January 19, 1916, written with particular reference to limited partnerships of the type created under the New York Statute, Laws of 1897, Ch. 427, § 3D, the treasury department gave its reasons for classifying limited partnerships with corporations. After quoting the language of Revenue Act of 1916, § 10 (a), which imposed a tax on "every corporation, joint-stock company or association, or insurance company * * * but not including partnerships" the letter stated that the term "partnership" as there used was a common-law term and applied only to such partnerships as were known to the common law. The treasury department later modified this ruling, drawing

In addition, the following types of limited partnership are held not to be taxable as corporations or associations: 1. A limited partnership organized under the laws of Mississippi.[7] 2. A partnership organized under the laws of Pennsylvania which does not use the word "limited" in the firm name, has no provision for a common seal or for limiting the liability of the members, or for annual meetings of the partners, but which is not dissolved by the death of one or more partners,[8] where in addition, the liability of only one partner is limited, there is no provision in the partnership agreement for the free transferability of partnership shares, and the books of account are to be open and accessible to each of the copartners at any time so that each copartner may at any and all times be fully cognizant and aware of the conduct of the business, has been held to be taxable as a partnership.[9] The following types of limited partnerships are held to be taxable as corporations or associations: 1. A partnership association or limited partnership organized under the Ohio code.[10] 2. A partnership association or limited partnership organized under the Virginia code of 1904.[11]

PARTNERSHIP ASSOCIATIONS. Under the 1909 law the attorney-general held that partnership associations organized under

a distinction between limited partnerships of the Pennsylvania type and New York type and holding that, for purposes of the income, excess-profits and capital stock taxes, limited partnerships of the New York type were partnerships and limited partnerships of the Pennsylvania type were corporations or joint-stock companies. (T. D. 2711; letter from treasury department dated May 4, 1918; I. T. S. 1918, ¶ 3355; telegram from treasury department dated April 24, 1918; I. T. S. 1918, ¶ 3325.)

[7] Hemingway's Ann. Miss. Code (1917), §§ 5467-5484. See S. 1165, T. B. 20-19-501. The above sections of the Mississippi Code show that limited partnerships formed thereunder are similar to those formed under the New York laws, in that general partners are not afforded limited liability although special partners do enjoy limited liability under certain conditions, and further, in that Mississippi limited partnerships do not sue in the partnership name and are in general so like common-law partnerships that they should be treated as such.

[8] O. D. 599, T. B. 30-20-1084. The partnership involved in this case had no provision for the free transferability of the interest of a member. It is to be noted that as a general rule limited partnerships of the Pennsylvania type are treated for income tax purposes as corporations. See p. 168.

[9] O. D. 800, T. B. 7-21-1440.

[10] §§ 8059-8078; see O. D. 444, T. B. 15-20-840.

[11] §§ 2878-2886. The status of Virginia limited partnerships formed under the Act of March 14, 1918, must be determined in each case by a consideration of the certificate of partnership and other pertinent facts. (O. D. 334, T. B. 29-19-671.)

the laws of Pennsylvania (referred to in the foregoing paragraph as limited partnerships of the Pennsylvania type), possessing every privilege and power essential to a corporation were properly taxable as corporations.[12] Such associations have capital contributed by the partners, who are not individually liable beyond the unpaid capital subscribed by each. The other characteristics of such associations which are more in the nature of a corporation than of a partnership are that the word "Limited" must be a suffix to the name, the interest of a partner may be transferred and new partners may be taken in by vote of a majority of the partners, and the association may sue or be sued in the association name. Michigan partnership associations are of this type and are held to be taxable as corporations.[13]

DIVIDENDS FROM LIMITED PARTNERSHIPS. The profits of limited partnerships of the Pennsylvania type should be treated by the members of the partnership as dividends of corporations are treated by stockholders.[14] Members of limited partnerships should ascertain if the partnership is paying a tax according to this requirement, and if so the normal tax should not again be paid on their shares of the profits.

PRIVATE OR PARTNERSHIP BANKS. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank, the interests of whose members can not be so transferred, is a partnership.[15]

Certain persons entered into an agreement to carry on a private banking business. Each member is liable for all debts, and in case of failure no "stockholder's" property is exempt. Profits are divided according to the amount each member has contributed. The interests of members are represented by certificates which can not be disposed of without the consent of the other members. The bank has been taxed as a partnership in the state where located. Although the bank issued certificates of ownership, the individuals possessing same were not exempt from the payment of debts of the bank out of their individual property. The fact that certificates can not be transferred without the consent of the other members makes it appear that new members can only get into the organization by mutual agreement, and that

[12] 28 Op. Atty. Gen. 189 (1910).
[13] Reg. 45, Art. 1506. See note 6.
[14] T. D. 2137.
[15] Reg. 45, Art. 1503; T. D. 2137.

such agreement constituted a new firm upon every change of certificate ownership. It was held that the bank must be treated as a partnership for the purpose of taxation.[16]

JOINT OWNERSHIP AND JOINT ADVENTURE. Joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not constitute a partnership. Co-owners of oil lands engaged in the joint enterprise of developing the property through a common agent are not necessarily partners.[17] It has been held that several persons who contributed severally to a fund used to develop and operate an oil field, with an agreement that they were to share pro rata in the profits, did not constitute a partnership.[18] Participation in the profits of an enterprise, while one of the well-known tests in determining whether any given agreement constitutes the parties thereto partners, is not conclusive, but merely raises a presumption of partnership.[19] It has been held in several oil cases that no presumption of partnership between co-owners of oil lands arises from the fact that they are jointly engaged in producing oil.[20] The use of the joint names of the individuals in the enterprise operates only to estop such individuals from denying a partnership liability in the case of third parties who were misled and dealt with the firm relying on such misrepresentation. It does not create a partnership where one does not exist.[21] The intention of the parties as gathered from the whole circumstances and evidence in each case should be considered.[22] In the absence of special facts affirmatively showing an association or partnership, where a vessel is owned by several individuals and operated by a managing owner or agent for the account of all, the relation does not constitute either a joint-stock association or a partnership.[23] An organization is not a joint venture if a majority in interest controls the business, has authority to elect a manager and the legal title to the property involved is in trustees for the benefit of a syndicate

16 O. D. 1083, T. B. 44-21-1895.

17 Reg. 45, Art. 1507.

18 Sol. Op. 117, T. B. 33-21-1772.

19 Meehan v. Valentine, 145 U. S. 611; Fechteler v. Palm Bros., 133 Fed. 462.

20 Neill v. Shamburg, 158 Pa. 263, 27 Atl. 992; Butler Savings Bank v. Osborne, 159 Pa. 10, 28 Atl. 163; Dunham v. Loverock, 158 Pa. 197, 27 Atl. 990.

21 Rowley on Partnership, ¶ 210.

22 Shea v. Nilima, 133 Fed. 209; In re Hirth, 189 Fed. 926.

23 Reg. 45, Art. 1507. Art. 1507 of Reg. 45 Rev., applies to situations arising under the Revenue Act of 1917 and 1918 (O. D. 411, T. B. 12-20-790).

and not the particular members, the organization being created expressly for the purpose of preserving the real estate of a dissolved corporation.[24] In case two partnerships enter into a single adventure under an agreement to terminate in two years, no part of the profit to be distributable and no drawings to be allowed during such period, the amount of profit realized and determinable each taxable year should be reported proportionately in the respective returns of the partnerships regardless of the agreement. The individual members of each partnership are likewise subject to tax each year on their distributive shares of the profit allocable to each partnership.[25] A partnership may exist in a single transaction as well as in a series of ventures, or an established business.[26] Two parties on several occasions had engaged in the enterprise of buying cattle in the fall, feeding them and selling them in the spring, the profits being equally divided between them. The two parties paid for the cattle by giving the commission merchants their joint note, secured by a chattel mortgage on the cattle. Feed was purchased through the proceeds of another joint note, which was discounted at a bank. After they were sold the notes were taken up and the profits divided equally. The same procedure had been followed in previous years and it was also followed in subsequent years. In one of the later years a resulting loss was borne equally by the two parties. There were no written articles of partnership, although it was admitted that the commission merchants with whom they dealt probably considered them to be partners, and a joint bank account was maintained in the names of both parties. The treasury department held that the enterprise was taxable as a partnership.[27] A married woman may become a partner in business with her husband.[28] The participation of two United States corporations in a joint enterprise or adventure does not constitute them partners.[29] As a general rule, a corporation cannot enter into a partnership for the reason that to allow a corporation to do so would be to place the power of binding the corporation in hands other than the duly elected directors and to place upon the stockholders

[24] O. D. 896, T. B. 18-21-1603.

[25] O. D. 187, T. B. 8-19-325.

[26] 18 L. R. A. (N. S.) p. 976, citing Flower v. Barnekoff, 20 Ore. 132, 25 Pac. 370, and other cases. See also Spencer v. Jones, 92 Tex. 516, 50 S. W. 118.

[27] A. R. R. 257, T. B. 35-20-1160. See also A. R. R. 629, T. B. 40-21-1850.

[28] A. R. R. 636, T. B. 41-21-1865.

[29] Reg. 45, Art. 1507.

burdens other than those to which they consent.[30] A corporation will not be held as a mining partner against its express refusal to be liable for any portion of the expense of operation, or to be responsible for the operation of mining property in which it has a one-eighth interest, merely because it receives a proportion of the profits realized from such operation equal to its interest in such property.[31] It has been held that corporations organized under the laws of Arkansas may not become members of a partnership.[32]

General Partnerships. A general partnership, or what is known as a common-law partnership, which Congress clearly intended to be exempt from the income tax law, is one which does not have a separate entity, but is composed of two or more individuals associated together for the purpose of carrying on a given business or transaction. Such a partnership has been defined by the courts as "a business organization in which every partner possesses full power and absolute authority to bind all the partners by his acts or contracts in relation to the business of the firm, in the same manner and to the same extent as if he held full power of attorney from them."[33] Among the principal elements of a general partnership are community of ownership of the partnership property, mutual responsibility and powers in the conduct of the partnership business, mutual liability, joint

30 Pearce v. Madison, etc. R. Co., 62 U. S. 441; Thomas v. Railroad. 101 U. S. 71; Pittsburgh, etc., R. Co. v. Keokuk, etc. Co., 131 U. S. 371; Whittenton Mills v. Upton, 10 Gray 582; Aurora State Bank v. Oliver. 62 Mo. App. 390; Mallory v. Hanaur Oil Works, 86 Tenn. 598, 8 S. W. 396.

31 Sol. Op. 36, T. B. 36-20-1179. See the paragraph General Partnerships.

32 A. R. M. 139, T. B. 42-21-1866.

33 Letter from treasury department dated January 19, 1916. This letter held all limited partnerships to be corporations for income tax purposes, as stated above. (See note 6.) The definition given is known as the test of mutual agency and has been criticised, as being neither strictly logical nor entirely satisfactory, on the ground that agency results from the partnership and not the partnership from the agency and on the ground that the existence of a relation of mutual agency is the very question at issue. (See Boreing v. Wilson, 33 Ky. L. 14, 108 S. W. 914.) There is great conflict of authority in the American decisions on the subject. The so-called "intention" test is usually applied as between the partners while as to third persons the profit-sharing test is often applied. No one test seems to be conclusive, the existence of a partnership being a question of fact upon which all the various tests may bear. (See Meehan v. Valentine, 145 U. S. 611; Haiku Sugar Co. v. Johnstone, 249 Fed. 103.) One of the chief elements of a partnership is the liability of a partner for its debts. Sharing of profits is but evidence of a partnership which may be rebutted by other evidence to the contrary. (Cox v. Hickman, 8 H. L. C. 268, 9 C. B. N. S. 47; Sol. Op. 36, T. B. 36-20-1179.)

and several, for the debts of the partnership and mutual interest in the profits of the same. Such partnerships are not subject to the tax, but the partners are taxed on their respective shares of the profits.[34]

If the interests of members of an organization are evidenced by negotiable certificates and the organization continues despite the death of a member, the organization is not a partnership.[35] An agreement, referred to as "Articles of Partnership," by the terms of which two individuals associate themselves as copartners in business under the name of A (one of the individuals) & Company for the period of five years, and under which one of the so-called partners is paid the same salary which he had theretofore received as an employee from the other individual, one-fourth of said salary being deductible from said individual's share of the profits, and which provides also that all capital is to be contributed by the individual whose name is used in the firm title, three-fourths of the profits going to said individual and one-fourth (less one-fourth of his salary) going to the other individual, losses to be borne by the partners in the same ratio as profits except that the excess of losses over gains, if any, are payable by the individual receiving three-fourths of the profits, the business to be carried on for the benefit of the firm by the survivor of either of the partners until the close of the current fiscal year in which the other partner may die, and upon final settlement the entire capital of the partnership and any increase thereof to go to the individual receiving three-fourths of the profits, or his estate, is held to be a partnership under the laws of Pennsylvania.[36]

Partnerships Consisting of Corporations. In a case arising under the 1913 law several corporations, organized under the laws of Hawaii, entered into a partnership with one another, the laws of Hawaii permitting such a combination for the transaction of any lawful business. The by-laws provided for management by representatives selected by the several partners, who were to represent the partners according to their respective interests. There were no special partners and there was no partnership capital stock. The by-laws provided for the existence of the association for 45 years unless sooner terminated by mutual consent. It was held that this provision did not show any

[34] Revenue Act of 1921, § 218; Revenue Act of 1918, § 218.

[35] O. D. 896, T. B. 18-21-1603. See Chicago T. & T. Co. v. Smietanka, 275 Fed. 60; T. D. 3193, T. B. 30-21-1741.

[36] S. 1361, T. B. 14-20-820.

plan for changeability in the membership; that dissolution would probably be effected through the transfer of any partner's interest; and that the association must be treated for income tax purposes as a partnership.[37] But the participation of two corporations in a joint enterprise would not constitute them partners.[38]

Partnerships Operating Abroad. No distinction is made in the law or regulations between domestic partnerships which operate entirely within this country and those which operate partly abroad. A partner's share of the net profits of the partnership is in all cases taxable in full if the partner is a resident or citizen of this country. If a partner is a nonresident alien many questions arise as to the extent to which he is properly taxable on the gains from business of the partnership conducted abroad. If the partnership is a limited partnership association under the provisions of some statute, similar to the Pennsylvania statute, the government will undoubtedly hold that the partner is taxable to the same extent as though it were a corporation, but if it is a general partnership, operating partly in a foreign country, the entire income therefrom can scarcely be considered as income arising within the United States, even though the partnership has an office in this country and the income is paid to the partner from that office, since a general partnership is not a separate entity interposed between the individual and the source of the income.[39]

Procedure in Collecting Income. With one exception, a domestic partnership is not subject to withholding at the source. But a partnership may be required to establish its identity and status by filing a certificate or statement showing it to be a partnership.[40] A new provision first inserted in the Revenue Act of 1918 and continued in the present law requires withholding at the source against partnerships in the case of interest on bonds, mortgages, or deeds of trust, or other similar obligations containing a so-called "tax-free covenant," thus giving partnerships

[37] Haiku Sugar Co. v. Johnstone, 249 Fed. 103. This case contains a discussion of the distinction between joint-stock companies and partnerships.

[38] Reg. 45, Art. 1507.

[39] U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27. A distinction is made by the treasury department under the 1918 Law between domestic corporations operating entirely within this country and those operating entirely abroad. (Reg. 45, Art. 92.)

[40] Revenue Act of 1921, § 221; T. D. 1957, T. D. 1998; telegram from treasury department dated May 17, 1918; I. T. S. 1918, ¶ 3362. See Chapter 40.

as well as individuals the benefit of such covenants.[41] Partnerships as well as all other recipients of income will be required to disclose their identity in the case of receiving fixed and determinable income from another under the provisions of law requiring information at the source.[42]

Duty in Paying Out Income. A partnership is under the same duty in paying out income as is an individual or a corporation; that is, in all cases required by law the tax must be withheld on payments of income to nonresident aliens, partnerships composed in whole or in part of nonresident aliens, and nonresident foreign corporations,[43] and information as to the name and address of the recipient must be obtained upon the payment of income to other individuals, partnerships or corporations.[44]

Net Income of Partnerships. The net income of a partnership is computed in the same manner and on the same basis as the net income of an individual except that a partnership is, unlike individuals, not allowed to deduct charitable contributions or gifts made within the taxable year.[45] The proceeds of life insurance policies paid upon the death of the insured to partnership beneficiaries need not be included in the gross income of the partnership under the 1918 law.[46] Under the present law the pro-

[41] Revenue Act of 1921, § 221; Revenue Act of 1918, § 221. See Chapter 40.

[42] See Chapter 39.

[43] Revenue Act of 1921, § 221; Revenue Act of 1918, §§ 221 and 237.

[44] See Chapters 39 and 40.

[45] Revenue Act of 1921, § 218 (c); Revenue Act of 1918, § 218 (d); Reg. 45, Art. 321. For the manner of computing the net income of partnerships under the 1916 Law, see Reg. 33 Rev., Art. 30. It seems that the partners may consider the contributions of the partnership as their own contributions, pro rata. Until very recently the rule under the 1916 Law was that partnerships were not permitted to deduct the amount of their Red Cross contributions, but the partners in computing their individual income taxes might deduct their proportionate amounts of such contributions subject, of course, to the 15% limitation. (Telegram from treasury department dated May 23, 1918; I. T. S. 1918, ¶ 3436.) Certain donations immediately and closely connected with the business of a partnership were held deductible under the 1916 Law. (Letter from the treasury department dated May 23, 1918; I. T. S. 1921, ¶ 553.)

It is now ruled that partnerships are entitled to deduct, under the 1916 Law, as amended by the Revenue Act of 1917, the amount of their charitable contributions (including contributions to the Red Cross) even though such contributions were not so closely connected with the trade or business as to secure to it some definite benefit or consideration, subject, of course, to the 15% limitation (A. R. R. 651, Sol. Op. 116, T. B. 45-21-1914). This subject is more fully considered in a later paragraph.

[46] Letter from treasury department dated November 18, 1919; I. T. S. 1921, ¶ 1208.

ceeds of life insurance policies paid upon the death of the insured is exempt income irrespective of who the beneficiary may be.[47]

Deductions. The deductions to which a partnership is entitled are the same as those allowed to individuals with the exception noted in the preceding paragraph.[48] In the case of limited partnerships of the Pennsylvania type reporting as corporations, the deductions should be made under the rules applicable to corporations. An individual may deduct from his gross income the ordinary and necessary expenses of his business, but this does not permit an individual who is a member of a partnership to deduct from his personal income any amounts expended therefrom for and on account of the partnership. The individual members of a partnership and the partnership itself are treated separately for income tax purposes, and the individuals comprising the partnership are not considered to be engaged in the business conducted by the partnership merely because they are members of the firm.[49] Certain special rulings made with respect to deductions by partnerships are given below.

Business Expense. Under the rules of various exchanges, seats must be issued in the names of individuals and may not be issued in the name of a partnership. In the case of a partnership which purchased seats on various exchanges from partnership funds, the seats being issued in the names of the individual members of the partnership, who might buy and sell for themselves as well as for the account of other persons, the amount expended being charged to "membership account" and carried as a capital expenditure on the partnership books, it has been held that the amounts so expended are investments of capital and not deductible as business expenses.[50] Where by the terms of a partnership agreement one of the members of the partnership is required to pay out of his own funds the compensation of one of the employes of the partnership who performs a part of the duties delegated to said member, it has been held that the amount so paid constitutes a proper deduction in the income tax return of the member.[51]

Losses. Where a corporation, all the stock of which is owned by a partnership, sustained a loss for each of the years from

47 Revenue Act of 1921, § 213 (b) (1).

48 Revenue Act of 1921, § 218 (c); Revenue Act of 1918, §§ 218 (d), 212.

49 O. D. 593, T. B. 29-20-1073.

50 O. D. 473, T. B. 17-20-885. In this case the partnership agreement contained no provision as to the disposition of the seats upon the termination of the partnership.

51 O. D. 947, T. B. 24-21-1686.

1915 to 1919 inclusive, it has been held that the partnership may not reduce its income by transferring partnership funds for the purpose of liquidating the loss of the corporation. The partnership and corporation are separate entities and no provision exists in the law under which a partnership and a corporation may file consolidated returns.[52] Where on July 1, 1920, the individuals comprising a partnership incorporated and acquired the entire capital stock in payment for the assets of the partnership with the exception of a few shares which were held by two employes, the partnership having shown a profit for the first six months of the year while for the last six months the return of the corporation showed a loss, it has been held that the loss of the corporation is not deductible in computing the net income of the predecessor partnership since there was no provision in the 1918 law for the taxing of partnership profits as profits of a successor corporation where the corporation comes into existence subsequent to July 1, 1919.[53]

PROFIT SHARING. It has been held that an arrangement whereby a partnership agreed with an expert to take charge of one of its departments upon a participation of profits basis, by which the expert served without salary and received his compensation in the form of 20% of the net profits of the department at the end of the year, established the relation of employer and employe, and that the compensation paid to the expert constituted a proper item of business expense to be deducted in computing the net income accruing to the partnership members.[54]

INSURANCE PREMIUMS. Premiums paid on life insurance policies covering the life of an officer, employe or of any person financially interested in any business conducted as a partnership are not permitted to be deducted in computing the profits of a partnership for the purpose of determining the distributive shares of the partners.[55] Premiums paid by a partnership for

[52] O. D. 795, T. B. 6-21-1431.

[53] A. R. R. 571, T. B. 29-21-1736. See Revenue Act of 1918, § 330. The Revenue Act of 1921, however, contains such a provision. See Revenue Act of 1921, § 229. See Chapter 10.

[54] Letter from treasury department dated June 30, 1916; I. T. S. 1919, ¶ 1297.

[55] Revenue Act of 1921, § 215 (a) (4); Revenue Act of 1918, § 215 (d); Revenue Act of 1916, as amended by the Revenue Act of 1917, § 32 (the reference to § 9 is apparently a mistake, the reference being intended to § 8 (e)). See Reg. 33 Rev., Art. 30. Under the 1916 Law, prior to the 1917 amendment, the treasury department permitted such premiums on life insurance to be deducted from year to year as paid and required the amount of the policy to be included in gross income in the year in which the policy matured and such amount was received. (T. D. 2090.)

accident and health insurance policies covering the lives of the individual partners are not deductible from gross income of the partnership.[56]

Distribution of Partnership Profits. The law has not been construed at any time to require the collection of the tax at the source on the distribution and payment of the profits of a partnership to the partners. No ruling has appeared under the 1918 law expressly requiring such deduction on payments to non-resident alien partners.[57]

Profits to Be Reported by Partners. The distributive share of the net income of a partnership which a partner is required to include in his return is his proportionate share of the net income of the partnership, either (a) for the taxable year upon the basis of which the partner's net income is computed, or (b) if the partner's net income is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, for any taxable year of the partnership ending within the taxable year upon the basis of which the partner's net income is computed. Amounts earned and distributed to a partner by a partnership after the end of its taxable year and before the end of his corresponding taxable year should be accounted for both by the partnership and by the partner in their returns for their next succeeding taxable years.[58] Both normal and surtaxes must be paid, upon this distributive share, except as noted below. When the annual profits are not distributed and paid to the partners, the respective interests of each partner in the undistributed profits for the year should be ascertained and the partners entitled thereto should include the amount of their respective interests in their returns as if the profits had been distributed and paid to them.[59] Such undivided annual profits of partnerships having been reported by the individual members thereof and the tax having been paid thereon, are not again taxable to the partners when actually distributed at a later date.[60] The distributive interests of the partners in the firm's net income should be the amount shown by the books when closed and not their distributive interests in the amount of income of the partnership represented by actual cash receipts, unless the partnership keeps its books on the basis of cash re-

56 O. D. 243, T. B. 13-19-422.

57 See I. T. S. 1918, ¶ 665. See Chapter 40.

58 Reg. 45, Art. 322.

59 Reg. 33, Art. 13. Revenue Act of 1921, § 218 (a); Revenue Act of 1918, § 218 (a).

60 Reg. 33, Art. 14.

ceipts and disbursements. Where accounts receivable, for instance, are entered on the books of the partnership as income and are treated as debts due from customers or clients, the partners' returns are required to be based on the total sum of such accounts receivable and not on the amount thereof that has actually been paid.[61]

Where a distribution of partnership profits is made in securities the partners will nevertheless be taxable with respect to their distributive shares of the net income of the partnership for the taxable year. No gain need be reported nor can any loss be claimed on account of any difference between the book value of the securities distributed and their market value at the date of distribution. In other words, the distribution of partnership profits in the form of securities, like a distribution of partnership assets upon dissolution, does not constitute a closed and completed transaction. To hold otherwise would be to hold that a person might sell at a profit or a loss to himself. The realization of any gain or loss with respect to such securities depends upon their subsequent sale after distribution.[62] Income from a particular source can not be allocated to one partner, but must be divided *pro rata* among the several partners.[63] Where a member of a partnership died owning certain shares of the common stock of a company subsequently becoming insolvent and under the plan of reorganization of such company holders of the common stock were required to pay a certain assessment per share, which assessment the decedent's estate was unable to meet, and where the partnership advanced the sum called for and underwrote the reorganization receiving for its services certain shares of stock of the reorganized company, as well as an amount of money, all of which was turned over to the decedent's estate and never entered upon the partnership's books, it has been held that since the stock and cash received by the partnership were for services performed by it as underwriter, such compensation represented taxable income to the members of the partnership regardless of the fact that no distribution of such funds was made to them and irrespective of the reason for which the partnership entered into the transaction.[64] Where an individual member of a partnership received a salary for services performed as an employee of a city and,

[61] Letter from treasury department dated February 28, 1916; I. T. S. 1919, ¶ 1285.

[62] T. B. R. 34, T. B. 10-19-354.

[63] O. D. 140, T. B. 4-19-221.

[64] O. D. 542, T. B. 24-20-998.

in accordance with his contract with the firm, turned over to it as the value of his time the entire amount so received, it has been ruled that the individual partner might deduct the amount of the salary in his personal return as a business expense, but that no exemption could be claimed by the partnership, since to allow the amount received by it to be treated as exempt income would in effect be to regard it as an employee of the city, which was not the fact.[65] The same rule applies where a partner turns over to the partnership the fees received by him as notary public under commission from a state.[66] A portion of the net income of the partnership for the taxable year may represent dividends or interest exempt from normal tax, interest from corporate bonds containing "tax-free covenants" and interest on bonds which may be wholly exempt from income tax, in which case the rules stated in the following paragraphs apply.

DIVIDENDS. For the purpose of the normal tax a partner is allowed a credit of his proportionate share of the income received by the partnership as dividends from a domestic corporation (except domestic corporations receiving a substantial portion of their income from sources within a possession of the United States) and foreign corporations 50% or more of the income of which for a certain period has been from sources within the United States.[67] Under the 1918 law, the credit was allowed with respect to dividends from (a) a corporation taxable upon its net income, and (b) a personal service corporation out of earnings or profits upon which income tax was imposed.[68] In the case of a partnership sustaining an operating loss and receiving dividends liable to surtax in the hands of the individual partners, such operating loss is to be applied to the reduction of such dividends so that only the *net* distributive shares of the partnership income will be included for purposes of the surtax.[69]

INTEREST ON NATIONAL BONDS. For the purpose of the normal tax only, a partner is allowed a credit of his proportionate share of the income received by the partnership as interest upon the obligations of the United States and bonds issued by the War Finance Corporation which is included in the gross income of the

[65] A. R. M. 25, T. B. 4-20-702.

[66] O. D. 648, T. B. 35-20-1167.

[67] Revenue Act of 1921, § 218 (b).

[68] Revenue Act of 1918, § 218 (a); Reg. 45, Art. 323; T. D. 2858. See Chapter 19.

[69] A. R. M. 13, T. B. 1-20-659.

partnership.[70] This credit of interest on national bonds for the purpose of the normal tax is unrestricted, because the interest on all national bonds is exempt from the normal tax. Interest upon obligations of the United States issued after September 1, 1917, other than postal savings certificates of deposits[71] and War Finance Corporation bonds is exempt from the surtax only to a limited extent and as provided in the respective acts authorizing the issue of such obligations or bonds, as amended and supplemented.[72] The Revenue Act of 1918 and the Revenue Act of 1921 provide that in the case of such obligations or bonds the interest shall be exempt only if and to the extent provided in the respective acts authorizing the issue thereof, as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under the income and war-profits and excess-profits taxes.[73] As income of a partnership is taxable to the individual partners, each partner is treated as the owner of a proportionate part of the bonds held by the partnership and is entitled to exemption on account of such partnership as if such partner owned such proportionate part of the bonds directly. Such partner, if a partner at the time of the original subscription by the partnership for bonds of the Fourth Liberty loan or notes of the Victory Liberty loan, as the case may be, is treated as an original subscriber for a proportionate part of such bonds or notes subscribed for by the partnership and is entitled to the appropriate collateral exemption of interest on bonds of previous issues on account of such original subscription for bonds or notes as if he had subscribed directly for such proportionate part.[74] Where Liberty bonds are subscribed for and continuously held by a partnership and one of the partners purchases the bonds directly from the partnership, the purchaser is entitled

[70] Revenue Act of 1921, § 218 (b); Revenue Act of 1918, §§ 218 (a), 216 (b); Reg. 45, Art. 323.

[71] Revenue Act of 1921, § 213 (b) (4).

[72] The amount of the exemption in the case of each issue is discussed in Chapter 18.

[73] Revenue Act of 1921, § 213 (b) (4); Revenue Act of 1918, § 213 (b) (4).

[74] Reg. 45, Art. 82; T. D. 2762. This principle also applies to stockholders in personal service corporations. Under the 1916 Law, as amended, interest upon the obligations of the United States issued after September 24, 1917, was required to be included in gross income of a partnership only to the extent to which the partnership's holdings exceeded $5,000 par value (see Form No. 1065), this being the exemption granted in the Second Liberty Bond Act for purposes of the surtaxes then in force. Under the present law "original subscription" and "continuous holding" are unimportant.

to the exemption which is conditioned upon original subscription to and continuous holding of the bonds. The basis of the exemption will be an amount of the bonds not in excess of (1) his original share of the bonds held by the partnership, or (2) his share of such bonds not sold by the partnership plus the amount bought by him from the partnership; whichever amount is smaller. However, if the bonds are purchased from another partner or they are sold by the partnership and repurchased by him in the open market, he can not claim such exemption in respect to any amount of the bonds so acquired.[75] Where a partnership was an original subscriber to Liberty bonds of the Fourth Liberty Loan and was reorganized as a corporation, an individual member of the partnership purchasing from the corporation certain of such bonds taken over will not be considered the "original subscriber" thereof.[76]

INTEREST ON BONDS OF STATES, POSSESSIONS AND POLITICAL SUBDIVISIONS. The interest received by the partnership on the obligations of a state or any political or taxing subdivision thereof and upon the obligations of the possessions of the United States, might, under the 1916 law, be deducted by a partner in proportion to his share of the total partnership profits.[77] It was unnecessary to provide for this deduction or credit under the Revenue Act of 1918, or the Revenue Act of 1921, since such interest, as well as interest upon obligations of a territory or any political subdivision thereof or the District of Columbia and securities issued under the Federal Farm Loan Act, is excluded from gross income,[78] and will not appear in the net income of the

75 O. D. 362, T. B. 2-20-672.

76 O. D. 502, T. B. 20-20-932.

77 This was undoubtedly intended to give the partner the benefit of the same exemption as was accorded to individuals or corporations under § 4 of the Revenue Act of 1916, although that section referred only to "political subdivisions" while the provision relating to partnerships refers to "political and taxing subdivisions." However, political subdivision has been construed to mean any subdivision of a state having the power to levy taxes so that the inclusion of the phrase "taxing subdivision" apparently did not extend any greater exemption to partners than to others.

78 Revenue Act of 1921, § 213 (b) (4); Revenue Act of 1918, § 213 (b). It was provided in the 1918 Law that every person (the term "person" including partnerships) owning any of the obligations, securities or bonds enumerated in the law to be absolutely exempt from the income tax—which includes the bonds referred to in the text above—should in his return of income submit a statement showing the number and amount of such obligations, securities or bonds owned by him and the income received therefrom in such form and with such information as the commissioner might require. (Revenue Act of 1918, § 213 (b) (4).) This provision is omitted from the 1921 Law.

partnership, which consists of its gross income less deductions.

Income Exempt to Partners. A member of a partnership who performed services in the military forces of the United States during the war, and according to agreement turned over to the partnership the compensation received for such services, might, under the 1918 law, in reporting his distributive share of the partnership's income, exclude from his return an amount equal to the sum received for military services and turned over to the partnership, but not in excess of $3,500. The other partner was required to report his entire distributive share of the income regardless of the fact that a portion of it was derived from his partner's compensation for military service.[79] An individual member of a partnership receiving a salary for services performed as an employee of a city, who turns over the entire amount so received to his firm as the value of his time, may deduct the amount of the salary in his personal return as a business expense, but the partnership may claim no deduction with respect thereto.[80]

Contributions to Charities. The proportionate share of contributions to charities made by a partnership may be claimed by the individual members of the partnership to an amount not in excess of 15% of the net income of the individual partners as computed without such deduction.[81]

Credit for Taxes. The provisions of the Revenue Act of 1921 that the tax computed shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States is discussed elsewhere in this book.[82] Where such taxes have been paid by a partnership, the income tax of an individual member thereof will be credited with the member's proportionate share of such taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.[83] Under the 1918 Law a partner, who is an alien resident of the United States and a citizen or subject of a foreign country, is entitled to such credit only for taxes paid or accrued to a possession of the United States, or to the foreign country of which he is a citizen or subject, and is not entitled to such credit for taxes paid or accrued to that country unless it allows a similar credit to a citizen of the United

[79] O. D. 121, T. B. 3-19-182. The 1921 Law does not contain the $3,500 exemption granted by the 1918 Law to those in active service.

[80] A. R. M. 25, T. B. 4-20-702.

[81] O. D. 185, T. B. 8-19-322.

[82] See Chapter 32.

[83] Revenue Act of 1921, § 222; Revenue Act of 1918, § 222.

States residing therein.[84] Under the Revenue Act of 1921 an alien resident is entitled to a credit of any income, war-profits and excess-profits taxes paid during the taxable year to *any foreign country* if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.[85]

READJUSTMENT OF PARTNERSHIP INTERESTS. When a partner retires from a partnership or it is dissolved, he realizes a gain or loss measured by the difference between the price received for his interest and the cost to him of his interest in the partnership, including in such cost the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. However, if such interest in the partnership was acquired prior to March 1, 1913, both the cost as hereinbefore provided and the value of such interest as of such date, plus the amount of the share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid, must be ascertained and the taxable gain derived or the deductible loss sustained be computed in accordance with the rules relative to the basis for determining gain or loss from sales set forth elsewhere in this book.[86] If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received on liquidation. Whenever a new partner is admitted to a partnership, or any existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the commissioner may determine whether any gain or loss has been realized by any partner.[87] The effect of the admission to a partnership of a new partner will depend upon the terms of his admission. If, under the terms of the partnership agreement he contributes property or cash to the capital of the partnership he acquires a right, upon dissolution, to a return of his contribution together with his proportionate share of the net profits of the partnership business, and in the meantime to a corresponding share in the net earnings of the partnership. There is no realization on the part of any partner. If, on the other hand, he purchases, for cash, an interest in the existing partnership, it is clear that what he has acquired is simply a right to share

84 Revenue Act of 1918, § 222 (a); Reg. 45, Art. 323.

85 Revenue Act of 1921, § 222 (a) (3).

86 See Chapter 17.

87 Reg. 45, Art. 1570, as amended by T. D. 3206; T. B. 33-21-1767.

in the profits of the partnership during its continuance and in any sum remaining, upon the dissolution of the partnership, after the satisfaction of creditors and of the equities as between the contributing partners. Since this would represent a purchase, by the incoming partner, there could be no realization as to him, and, as to the members of the former partnership, the amount paid by him will clearly be income to them in direct proportion to their respective interests in the former partnership and should be returned by them as such.[88]

Fiscal Year. The net income of a partnership is computed generally in the same manner and on the same basis as the net income of individuals.[89] Its net income must be computed upon the basis of the partnership's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of the partnership. If no such method of accounting has been employed, or if the method employed does not clearly reflect income, the computation is made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect income. If the partnership's annual accounting period is other than a fiscal year, or if the partnership has no annual accounting period or does not keep books, its net income will be computed on the basis of the calendar year.[90] If the net income of a partner is computed on the basis of a period different from that upon the basis of which the net income of the partnership is computed, then the partner's distributive share of the net income of

88 Sol. Op. 42, T. B. 36-20-1182; O. 816, T. B. 3-19-197.

89 Revenue Act of 1921, § 218 (c); Revenue Act of 1918, § 218 (d).

90 Revenue Act of 1921, § 212 (b); Revenue Act of 1918, § 212 (b). Prior to the enactment of the Revenue Act of 1918 reporting on the basis of a fiscal year was a privilege; now it is a requirement, if the books of the partnership are kept on the basis of a fiscal year. (See Chapter 34.) Under the 1916 Law a partnership had the same privilege of fixing and making returns upon the basis of its own fiscal year as was accorded to corporations. If a fiscal year ended during 1916 or during a subsequent calendar year for which there was a rate of tax different from the rate of the preceding calendar year, the rate for the preceding calendar year applied to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such preceding calendar year bore to the full fiscal year and the rate for the calendar year during which such fiscal year ended applied to the remainder of such profits. (Revenue Act of 1916, § 8 (e) as amended by the Revenue Act of 1917.) Prior to this amendment of the statute the treasury department held that where the fiscal year of a partnership ended at any time other than December 31st the total profits of the partnership were required to be reported as income of the partners for the calendar year in which the fiscal year of the partnership ended.

the partnership for any accounting period of the partnership ending within the fiscal year or calendar year upon the basis of which the partner's net income is computed, is included in computing the net income of each partner.[91] Under the 1918 Law if the fiscal year of a partnership ends during a calendar year for which the rates of tax differ from those for the preceding calendar year, then (1) the rates for such preceding calendar year apply to an amount of each partner's share of such partnership net income equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends apply to the remainder.[92] If the fiscal year of a partnership begins in 1920 and ends in 1921, or begins in 1921 and ends in 1922, (1) the rates for the calendar year during which such fiscal year begins will apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends will apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year.[93]

Net Losses of Partnership. Where the result of partnership operation is a net loss, the loss will be divisible between the partners in the same proportion as a profit would have been divisible, and may be used by the individual partners in their returns of income,[94] as the loss of a partnership is considered to be a loss sustained in trade by the individual members. The partner may deduct the loss whether he is compelled to make

91 Revenue Act of 1921, § 218 (a); Revenue Act of 1918, § 218 (a).

92 Revenue Act of 1918, § 218 (b). In the case of an individual member of a partnership making return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess-profits tax imposed upon the partnership under the Revenue Act of 1917 with respect to that part of such fiscal year falling in 1917, was deducted from that part of the income subject to the 1917 rates, and not from that part subject to the 1918 rates. (Revenue Act of 1918, § 218 (c).) For the detailed rule as to the application of the different tax rates in the case of partnerships with fiscal years ending in 1916, 1918 and 1919, see respectively O. 1016, T. B. 14-20-833, Reg. 45, Arts. 324-5 and Reg. 45, Arts. 326-7.

93 Revenue Act of 1921, § 205 (c).

94 Reg. 33 Rev., Art. 30.

good his proportionate share by payment of money to the partnership or whether the loss is charged against profits accrued to his account in preceding years.[95] If the loss occurs in a fiscal year covering a period in which there is a change of tax rates it does not seem that under the Revenue Act of 1918 the loss should be prorated although the income, if any, would be, since a loss is deductible in the year in which it is actually sustained.[96] Under the Revenue Act of 1921, however, if, in order to clearly reflect the income, the loss should, in the opinion of the commissioner, be accounted for as of a different period it may be deducted in a year other than the one in which sustained.[97]

Profits Earned Prior to March 1, 1913. In a case arising under the 1913 law it was contended that where the fiscal year of a partnership ended between March 1, 1913, and December 31st of the same year, the equitable method would be to apportion the profits for the fiscal year in equal monthly installments and allot to the period preceding March 1st its proper proportion, making the partners taxable only on their respective shares in the remainder. The court held that the plaintiff in this case failed to show that profits were earned by the partnership prior to March 1, 1913, and in what sum, and in the absence of such showing the court assumed that the tax was legally collected.[98] The treasury department held under the 1913 Law that the entire amount of profits accruing to a partner at the close of the fiscal year of the partnership was taxable in the calendar year in which the fiscal year ended,[99] although a part of the fiscal year may have covered a period prior to the incidence of the tax.

Returns by Partnerships. Every partnership must make a return of income, regardless of the amount of its net income. The return under the 1918 Law was on form 1065 (revised). The return should be sworn to by one of the partners. Such return should be made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year as the case may be), irrespective of the taxable years of the partners.[100] A receiver in charge of the business of a partnership must make a return for it on form 1065 (revised). As the death or withdrawal of a partner ordinarily dissolves the

95 Letter from treasury department dated February 12, 1915; I. T. S. 1918, ¶ 674.

96 See Chapter 25.

97 Revenue Act of 1921, § 214 (a) (6).

98 Cohen v. Lowe, 234 Fed. 474.

99 T. D. 2090.

100 Revenue Act of 1921, § 224; Revenue Act of 1918, § 224; Reg. 45, Arts. 411 and 412. If the partnership makes any change in its accounting

partnership, a return would be required covering the period from the beginning of the partnership's taxable year to the date of its dissolution. If the business of the partnership is continued as such, a new accounting period would be established upon the necessary reorganization of the partnership, and its next return should cover the period from the date of reorganization until the end of the taxable year.[101]

CONTENTS OF PARTNERSHIP RETURN. Under the 1918 law the return of a partnership was required to state specifically (a) the items of its gross income; (b) the deductions to which it is entitled under the law; (c) the amounts of dividends from taxable corporations and from personal service corporations out of earnings and profits upon which income tax has been imposed, and of interest upon obligations of the United States and bonds of the War Finance Corporation included in gross income; (d) the amount of any income, war-profits and excess-profits taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (e) the names and addresses of the individuals who would be entitled to share in the net income of the partnership if distributed; (f) the amount of the distributive share of such net income of each such individual; and (g) such other facts as are required by form 1065 (revised).[102]

RETURNS OF TAX WITHHELD AT SOURCE. Partnerships are required to make returns on or before March first of each year of amounts of tax required to be withheld at the source.[103]

period, it should make its return in accordance with the provisions of § 226 of the statute and Reg. 45, Art. 431. Prior to the enactment of 1918 Law, partnerships as such were not required to render annual returns of income, but when requested by the commissioner, or any collector, were required to make a correct return of earnings, profits and income, showing their gross income and the deductions and credits allowed by the law and the names and addresses of the individuals who would be entitled to the net earnings, profits and income if distributed. It was not required in such returns that the partnership report income exempt under § 4 of the 1916 Law. (Revenue Act of 1916, § 8 (e); Reg. 33 Rev., Art. 30; Reg. 33, Art. 12.) Special returns from partnerships were required generally in 1913, but no returns were required for the year 1914 or for subsequent years, except in instances where it was specially required by the commissioner or a collector. In 1917 partnerships were required to file returns of income for the excess-profits tax.

101 O. D. 228, T. B. 12-19-403.

102 Reg. 45, Art. 412.

103 Revenue Act of 1921, §§ 221 (c) and 237; Revenue Act of 1918, §§ 221 (c) and 237; Reg. 45, Arts. 361-376; see Chapter 40.

Returns of Information. Partnerships are required to file such returns as are required under the provisions of law relating to information at the source.[104]

Reports by Brokers. Every partnership doing business as a broker is required, when called upon by the commissioner, to make a return showing the names of its customers with such details as to the profits, losses or other information which the commissioner may require, as to each of such customers, as will enable the commissioner to determine whether all income tax due on the profits or gains of such customers has been paid.[105] This report is for the purpose of information at the source and is more fully discussed in another chapter.[106]

Penalties. Partnerships or their members or employes are subject in certain cases to penalties, both specific and *ad valorem,* for failing or refusing to make returns, to supply information, to pay or collect any tax, or for wilfully attempting in any manner to defeat or evade the income tax. Such penalties are more particularly discussed in another chapter.[107]

Examination of Partnership Records. All partnership books, papers, records or memoranda are subject to examination by any revenue agents or inspectors designated by the commissioner for the purpose of ascertaining the correctness of returns which have been made, or making a return where none has been made, in accordance with and subject to rules which are discussed at length in another chapter.[108]

Foreign Partnerships. The distinction between domestic and foreign partnerships is given above.[109] The Revenue Acts of 1918 and 1921 do not use the word "foreign" in connection with partnerships in the part of the act imposing the income tax.[110] The acts, however, provide that individuals carrying on business in partnership shall be liable for income tax in their individual capacity. This implies that the income of a foreign partnership from sources within the United States is taxable in the hands of the nonresident alien partners, to the extent included in the

[104] Revenue Act of 1921, § 256; Revenue Act of 1918, § 256; Reg. 45, Arts. 1071-1080.

[105] Revenue Act of 1921, § 255; Revenue Act of 1918, § 255; Reg. 45, Art. 1061.

[106] See Chapter 39.

[107] See Chapter 36.

[108] See Chapter 38.

[109] See p. 166.

[110] The term "foreign" is applied to partnerships in the title imposing stamp taxes. (Revenue Act of 1921, Title XI, Schedule A-13; Revenue Act of 1918, Title XI, Schedule A-15.)

distributive share of each, and such has been the ruling of the treasury department.[111] The income received by a nonresident alien partnership from sources within the United States does not, like the income received by a domestic or resident alien partnership, lose its identity as to source when distributed to a nonresident alien member of a firm.[112] If the partner is a citizen or resident of this country, he is of course subject to tax upon his entire distributive share of the profits of any partnership of which he may be a member. Foreign partnerships are divided into two classes: (1) resident foreign partnerships, and (2) nonresident foreign partnerships. A foreign partnership which is engaged in business or trade within the United States and has an office or place of business therein is a resident foreign partnership, and a foreign partnership which is not engaged in business or trade within the United States and has no office or place of business therein is a nonresident foreign partnership.

EXTENT TO WHICH TAXABLE. Foreign partnerships, unless they are of the kind taxable as corporations,[113] are not taxable, but the partners are required to pay the tax in all cases on their distributive shares of the profits, gains or income of the partnership arising from sources within the United States. A complete discussion of the term "income from sources within the United States" is contained in another chapter.[114] In a recent case under the 1918 law it appeared that two members of a British partnership, engaged in the cotton business, resided in England, and the third resided temporarily in the United States. The partnership maintained an office in this country for the purpose of *purchasing* cotton to be shipped abroad. The purchase price was paid by draft drawn on England. None of the cotton so purchased was sold within the United States, nor were any of the profits of the sale received in this country. The treasury department held that any income derived from the sale of such cotton was not taxable as income from sources within the United States, since the sale was consummated in a foreign country through transactions by the home office. The third member of the partnership who remained within the United States seven

111 Letter from treasury department dated April 7, 1917; I. T. S. 1918, ¶ 702; Letter from treasury department dated June 6, 1918; I. T. S. 1918, ¶ 3528; Letter from treasury department dated October 1, 1918; I. T. S. 1921, ¶ 1700; Letter from treasury department dated December 6, 1916; I. T. S. 1921, ¶ 1701.

112 Letter from treasury department dated October 1, 1918; I. T. S. 1921, ¶ 1700.

113 See the discussion of Limited Partnerships on p. 167.

114 See Chapter 4.

or eight months of the year for the purpose of transacting the partnership business, and who returned to Europe when this purpose was accomplished, was held to be a nonresident alien and therefore not taxable with respect to his share of the partnership profits so held to be from sources without the United States.[115] A foreign partnership is liable for tax under the 1917 act on the entire amount of profit derived from the sale of goods through its branch office or through its agencies in the United States. The basis of computation of profits should be the difference between the cost of the goods sold through its branch office or agent in the United States and the price received therefor and not merely the amount disclosed by the books of the branch office in the United States.[116]

Collection of the Tax at the Source. Under the Revenue Act of 1918, a partnership, resident or non-resident, is not subject to having any tax withheld at the source on income from sources in this country, except in the case of interest upon bonds of corporations containing covenants to pay the tax.[117] The treasury department under the 1916 law made no distinction

[115] O. D. 593, T. B. 29-20-1072.

[116] O. D. 311, T. B. 25-19-585.

[117] Revenue Act of 1918, § 221 (b); Reg. 45, Art. 361. Withholding was not required in any case on payments to a resident foreign partnership under the 1916 Law. Nonresident foreign partnerships were also not subject to having the tax withheld on interest from investments in the bonds or similar obligations of domestic or resident corporations (telegram from treasury department dated May 17, 1918; I. T. S. 1918, ¶ 3362) or on dividends (Reg. 33 Rev., Art. 32; letter from treasury department dated June 6, 1918; I. T. S. 1918, ¶ 3528) on the stock of corporations or other income. The language of the Revenue Act of 1916, § 13 (e), as amended, was ambiguous. It provided that the provisions relating to withholding of the tax should be made applicable "to the tax imposed by subdivision (a) of § 10 upon incomes derived from interest upon bonds and mortgages or deeds of trust or similar obligations of domestic or other resident corporations * * * by nonresident alien firms." No tax, as a matter of fact, was imposed upon firms or partnerships by subdivision (a) of § 10, and consequently it was ruled that no tax need be withheld.

[118] Telegram from treasury department dated May 17, 1918; I. T. S. 1918, ¶ 3362. It is interesting to note in this connection that immediately after the 1913 Law was enacted and before it was held that partnerships were not subject to withholding the treasury department provided for the use of partnerships an ownership certificate which required a statement of the names and addresses of each of the partners. No such disclosure of the names of the partners of nonresident foreign partnerships was subsequently required, which indicates that the treasury department did not consider the individual status of the partners to be essential in determining whether or not withholding is necessary.

based upon the status of the individual partners and no such distinction was made under the 1918 law.[118] Under the 1921 law, however, withholding is required against partnerships composed in whole or in part of non-resident aliens to the same extent as against non-resident alien individuals.[119]

PROCEDURE IN COLLECTING INCOME. Under the 1918 law, in collecting income from interest on bonds not containing a "tax-free covenant" a resident or non-resident foreign partnership made use of a form certifying that it was not subject to having the income tax withheld at the source.[120] In collecting any other form of income no prescribed certificate was necessary, but the partnership might be called upon to disclose its name and location for the purpose of supplying the payor of the income with the information which he was required to transmit to the government.[121]

DUTY IN PAYING OUT INCOME. Resident foreign partnerships are under the same duty in paying out income to others as are domestic partnerships; that is, they are required to withhold on payments made from the office in this country under the same conditions which require domestic partnerships to withhold. They are also required to report the names of those to whom they pay fixed or determinable income, in the manner required by law of corporations, partnerships, and individuals generally.[122]

[119] Revenue Act of 1921, § 221 (a). See Chapter 40.

[120] Reg. 45, Art. 365. Form No. 1001 (revised) is used for this purpose.

[121] For the 1916 procedure in this respect see Reg. 33 Rev., Art. 43. Telegram from treasury department dated May 21, 1918; I. T. S. 1918, ¶ 3364. See I. T. S. 1918, ¶ 3452a.

[122] See Chapters 39 and 40.

CHAPTER 9

PERSONAL SERVICE CORPORATIONS

In an attempt to equalize the relative tax burdens of corporations and partnerships the Revenue Act of 1918 prescribed a new system of taxation for a certain type of corporation, which it called a personal service corporation. Personal service corporations are corporations whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor. The term "personal service corporation" does not include, however, any foreign corporation, or any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[1] Personal service corporations as such are not subject to the income, war-profits or excess-profits taxes imposed by the Revenue Act of 1918 and the Revenue Act of 1921 for the year 1921, the individual stockholders thereof being taxed in the same manner as the members of partnerships.[2] The latter statute, however, abolishes the exemption of personal service corporations as of December 31, 1921. Thereafter personal service corporations are to be treated in the same manner as all other corporations. The discussion in this chapter is, therefore, limited to the years 1917 to 1921, inclusive. The Revenue Act of 1921 also imposes an alternative retroactive tax on personal service corporations in the event that the scheme of taxation of such corporations is held unconstitutional and invalid, and this provision will be discussed below.

All the provisions of law discussed in the preceding chapter relating to partnerships and the members thereof apply, so far

[1] Revenue Act of 1921, § 200 (5); Revenue Act of 1918, § 200. The definition is the same in the two laws. For a definition of the term "Government Contract," see Reg. 45, Art. 1510, and Revenue Act of 1921, § 2 (11).

[2] Revenue Act of 1921, §§ 231 (14), 218 (d); Revenue Act of 1918, §§ 231 (14), 218 (e); Reg. 45, Art. 328. In making returns for fiscal years beginning in 1917, personal service corporations were not treated wholly as such

as practicable, to personal service corporations and the stockholders thereof, provided that amounts distributed by a personal service corporation during its taxable year be accounted for by the distributees (i.e., the persons who actually receive the dividends); and any portion of the net income remaining undistributed at the close of its taxable year must be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.[3] Thus, the individual stockholders of personal service corporations are taxable upon their distributive shares in the same manner as the members of partnerships, and the corporation is subject to neither income nor excess-profits taxes.[4]

Definition. The statutory definition of personal service corporations has been given above. By regulation the term "personal service corporation" is defined as a corporation, not expressly excluded, the income of which is derived from a profession or business (a) which consists principally of rendering personal service, (b) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (c) in which the employment of capital is not necessary or is only incidental. No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's return whether or not it is a personal service corporation.[5] The general principles under which such determination will be made are stated in the following paragraphs.

CERTAIN CORPORATIONS EXCLUDED. The following classes of corporations are expressly excluded from classification as personal service corporations: (a) foreign corporations; (b) corporations 50 per centum or more of whose gross income consists of gains, profits or income derived from trading as a principal; and (c) corporations 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, inclusive. A corporation is not a personal service corporation merely because less than 50 per centum of its gross income was derived from trading as a principal or from government contracts.[6] A corporation can

[3] Revenue Act of 1921, § 218 (d); Revenue Act of 1918, § 218 (e).

[4] Reg. 45, Art. 328.

[5] Reg. 45, Art. 1523.

[6] Reg. 45, Art. 1524. This rule was applied in A. R. M. 120, T. B. 15-21-1558, where 25% of the earnings of the corporation were derived from trading as a principal. No other reason against personal service classification

not be considered a personal service corporation when another corporation owns or controls substantially all of its stock, or when substantially all of its stock and of the stock of another corporation (not itself a personal service corporation) forming part of the same business enterprise is owned or controlled by the same interests.[7]

In a case in which this ruling was applied, the recommendation has been made that the ruling be modified so as to allow both the parent corporation and its subsidiaries to be classed as personal service corporations, provided they fulfill all other requirements for such qualification.[8]

Personal Services Rendered. In order that a corporation may be deemed to be a personal service corporation its earnings must be derived principally from compensation for personal services rendered by the corporation to the persons with whom it does business. Merchandising or trading either directly or indirectly in commodities or the services of others is not rendering personal service. Conducting an auction, agency, brokerage, or commission business strictly on the basis of a fee or commission is rendering personal service. If, however, the corporation assumes any such risks as those of market fluctuation, bad debts, failure to accept shipments, etc., or if it guarantees the accounts of the purchaser or is in any way responsible to the seller for the payment of the purchase price, the transaction is one of merchandising or trading and this is true even though the goods are shipped directly from the producer to the consumer and are never actually in the possession of the corporation. The fact that earnings of the corporation are termed commissions or fees is not controlling. The fact that a commission or fee is based on a difference in the prices at which the seller sells and the buyer buys raises a presumption that the transaction is one of merchandising or trading, and it will be so considered in the absence of satisfactory evidence to the contrary.[9]

appeared. The statute prescribes 50% as the amount of trading as a principal which disqualifies a corporation from being classed as a personal service corporation, and the intent of the 1917 Act was similar. Where the statute prescribes 50% as the limit, and there is only 25% of such trading, a corporation would seem to be a personal service corporation unless some other factor required a different conclusion. The validity of the ruling upon the theory that capital was a material income-producing factor is doubtful.

[7] Reg. 45, Art. 1524; O. D. 1, T. B. 1-19-4.

[8] A. R. R. 46, T. B. 13-20-802.

[9] Reg. 45, Art. 1525. It is perhaps the most fundamental *positive* essential to personal service classification that the earnings of a corporation be de-

Personal Service Rendered: More Than One Business. It frequently happens that corporations are engaged in two or more professions or businesses which are more or less related, one of which does not consist of rendering personal service. Thus an engineering concern may also engage in contracting, which amounts to trading in materials and labor, a brokerage concern may guarantee some of its accounts, a photographer may sell pictures, frames, art goods, and supplies, or a dealer in a commodity may furnish expert advice or services with respect to its installation, use, etc. In such case the corporation is not a personal service corporation unless the non-personal service element is negligible or merely incidental and no appreciable part of its earnings is to be ascribed to such sources.[10]

Activities of Stockholders. In determining whether a corporation is a personal service corporation, no weight can be given to the fact that it renders personal services unless (a) the principal owners or stockholders are regularly engaged in the active conduct of its affairs and are engaged in such a manner that the earnings are to be ascribed primarily to their activities, and (b) its affairs are conducted principally by such owners or stockholders.[11] Where the principal owners or stockholders do not render the principal part of the services, but merely supervise or direct a force of employees, the corporation is not a personal service corporation. If employees contribute substantially to the services rendered by a corporation, it is not a personal service corporation unless in every case in which services are so rendered the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the principal owners or stockholders and such fact is evidenced in some definite manner in the normal course of the profession or business. The fact that the principal owners or stockholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business, the principal owners or stockholders of which do not devote personal attention to the management or supervision of its affairs,

rived "principally from compensation for *personal* services rendered by the corporation to the persons with whom it does business." The force of the word "principally," as well as the word "primarily," as used in the statute is discussed in A. R. R. 463, T. B. 41-21-1858.

[10] Reg. 45, Art. 1526.

[11] Reg. 45, Art. 1527.

does not of itself constitute the corporation a personal service corporation.[12]

Activities of Stockholders: Stock Interest Required. No definite percentage of stock or interest in the corporation which must be held by those engaged in the active conduct of its affairs in order that they may be deemed to be the principal owners or stockholders can be prescribed as a conclusive test, as other facts may affect any presumption so established. No corporation or its owners or stockholders may, however, make a return in the first instance on the basis of its being a personal service corporation unless at least 80 per centum of its stock is held by those regularly engaged in the active conduct of its affairs.[13]

[12] Reg. 45, Art. 1528; A. R. R. 464, T. B. 17-21-1588. The statute does not require that the "affairs" of a personal service corporation be "conducted principally" by its "owners or stockholders." The regulations given in the text above are in this respect an attempt to put into the body of the statute a limitation which Congress did not think it necessary to prescribe. The statute itself simply requires that the principal owners or stockholders be "regularly engaged" in the active conduct of the affairs of a personal service corporation and that the earnings of the corporation be such as may be ascribed "primarily" to the activities of such owners or stockholders. It does not require that the affairs of the corporation be conducted "principally" by its owners or stockholders. The principal owners of a corporation might be "regularly engaged" in the conduct of its affairs so that its earnings would be ascribed "primarily to their activities," and yet the activities of a corporation might be conducted, at least on a quantitative basis, "principally" by nonstockholding employees. Insofar as this regulation extends the terms of the statute its validity is to be questioned (See Morrill v. Jones, 106 U. S. 466, and cases cited upon this point in Chapter 47). There is no requirement, furthermore, that the principal owners or stockholders shall attend to all the detail of a business. (See A. R. R. 463, T. B. 41-21-1858.)

[13] Reg. 45, Art. 1529. This regulation is to be read in connection with Reg. 45, Art. 1524, in which it is held that a corporation can not be considered a personal service corporation when another corporation owns or controls substantially all of its stock. The basic theory underlying these rulings is that a corporation cannot render *personal* services. The statute, however, does not require that *all* the owners and stockholders of a personal service corporation must be regularly engaged in the active conduct of its affairs and that the earnings of the corporation be such as can be ascribed completely to the activities of such owners and stockholders. It is careful to avoid any such absolute requirement. If the 80% limitation given in the text above is intended to be anything more than *prima facie*, it would seem to be a perversion of the statute. For according to their natural, ordinary and familiar meaning, which must control in ascertaining the legislative intent (DeGanay v. Lederer, 250 U. S. 376, 239 Fed. 568, and cases cited in Chapter 47) the words "principal" and "primarily" do not necessarily imply a percentage as high as 80%. This

ACTIVITIES OF STOCKHOLDERS: CHANGE IN OWNERSHIP. The fact that the owners or stockholders of the corporation may change during the course of the taxable year does not take a corporation which is normally in the personal service class out of that class. Frequent changes in the ownership of any substantial interest or number of shares is, however, evidence bearing on the question as to whether the principal owners or stockholders are actively engaged in the conduct of the affairs of the corporation. The incapacity, retirement or death of a principal owner or stockholder who has been actively engaged in the conduct of its affairs will not be deemed to make any change in the status of the corporation during a reasonable time thereafter.[14]

CAPITAL. In determining whether a corporation is a personal service corporation, no weight can be given to the fact that the invested capital for purposes of the excess-profits tax or the actual investment of the principal owners or stockholders is comparatively small. The test established by the statute with respect to capital is entirely different. That test is the nature of the profession or business as indicated (a) by the kind of service it renders and (b) the extent to which capital is required to carry on such profession or business.[15] If the use of capital

conclusion is fortified by a statement of Mr. Kitchin, the chairman of the Ways and Means Committee of the House of Representatives, made on March 18 and 19, 1920, in regard to Sec. 200 of the Revenue Act of 1918. Mr. Kitchin said at that time: "It (a personal service corporation) may have a thousand stockholders, but four men may own, say 75 or 60 per cent. of the stock, and these four men, say the president, the secretary, the manager, and supervisor, or whatever they may be, give their active service to it, and you can attribute the profits they may make, or substantially all of their profits, to their services, then it is a personal service corporation under that section." Statements by a committee chairman in charge of a bill may be referred to upon questions of legislative intent (Lapina v. Williams, 232 U. S. 78, and cases cited in Chapter 47).

[14] Reg. 45, Art. 1530.

[15] Reg. 45, Art. 1531; A. R. R. 464, T. B. 17-21-1588. This ruling is clearly unsound. In determining the extent to which capital is required to carry on a profession or business, there would seem to be no better evidence than the extent to which capital is in fact employed in a profession or business. The rule stated professes to determine the extent to which capital is required without reference to the actual investment of capital by the principal owners or stockholders. No clearer indication of the fact that capital is not required could be supplied than the fact that it has not been invested. If it has not been invested, it can hardly be required. On the other hand, if it is invested, it is usually invested because it is required. The amount of invested capital or the actual investment of the principal owners or stockholders should be taken into consideration in determining the extent to which capital is required in a business. As a matter of fact, it is so taken into consideration. In the last sentence of

is necessary or more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation. No corporation is a personal service corporation if it carries on business of a kind which ordinarily requires the use of capital, irrespective of whether the owners or stockholders have actually invested a substantial amount of capital.[16]

CAPITAL: INFERENCE FROM USE. The term "capital" means not only capital actually invested by the owners or stockholders, but also capital secured in other ways. Thus, if capital is borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable or other paper, or indirectly as shown by accounts payable or other forms of credit, or if the business of the corporation is in any way financed by or through any of the owners or stockholders, these facts will be deemed evidence that the use of capital is necessary. If a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or other reasons such practice is necessary in order to secure or hold business which otherwise would be lost, and that the corporation is not a personal service corporation. If a corporation engaged in an agency, brokerage, or commission business regularly employs a substantial amount of capital to lend to principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, it is not a personal service corporation. In general the larger the amount of the capital actually used the stronger is the evidence that capital is necessary and is a material income-producing factor and that the corporation is not a personal service corporation.[17]

Article 1532 of Regulations 45, the treasury department holds that the larger the amount of capital actually used, the stronger is the evidence that capital is necessary. The converse of this proposition is equally true. The smaller the amount of capital actually used, the stronger is the evidence that capital is not necessary.

[16] Reg. 45, Art. 1531. This ruling is also a misinterpretation of the statute. The question to be determined in regard to any corporation claiming personal service classification is not whether corporations doing a similar business ordinarily require the use of capital, but whether the particular corporation under consideration in fact requires the use of capital. The fact that similar corporations do ordinarily require the use of capital may be evidential, but it should certainly not conclusively preclude personal service classification if a corporation in fact does not employ capital in carrying on its business.

[17] Reg. 45, Art. 1532. See foot note 13. The distinction between capital invested and held in a corporation and capital actually used should not be

Additional Principles Bearing Upon Personal Service Classification: Examples. The Revenue Act of 1917 contained a provision to the effect that in the case of a trade or business "having no invested capital or not more than a nominal capital," there should be levied, assessed, collected, and paid an excess-profits tax of 8% of the net income.[18] The regulations interpreting this provision stated that it applied primarily to occupations, professions, trades and businesses engaged principally in rendering personal service in which the employment of capital is not necessary and the earnings of which are to be ascribed primarily to the activities of the owners. These regulations also provided that no weight would be given to the fact that a business was carried on by means of personal services, unless the principal owners were regularly engaged in the active conduct of the business.[19] It will be noted that this provision of the Revenue Act of 1917, as construed by the treasury department, is closely analogous to the personal service corporation provision of the Revenue Act of 1918. Several cases have arisen in which the applicability of the above provision of the Revenue Act of 1917 and the personal service corporation provision of the Revenue Act of 1918, or both, has been discussed at some length with reference to a more or less complicated state of facts.

The question whether a particular business is one having not more than a "nominal capital" or is such as to render a corporation a personal service corporation within the meaning of

forgotten. The fact that a corporation has a substantial capital or earned surplus may not preclude personal service classification, if this capital or earned surplus is not necessary to the prosecution of the business of the corporation; and the fact that it is not necessary may be indicated by the manner in which it is invested. There is nothing in the statute preventing the accumulation of surplus or profits by a personal service corporation. This is expressly stated by Mr. Kitchin, the chairman of the Ways and Means Committee of the House of Representatives (hearings before the committee on Ways and Means, House of Representatives, March 18 and 19, 1920, p. 38), and this statement is admissible evidence of legislative intent (U. S. v. St. Paul M. & M. R. Co., 247 U. S. 310, and cases cited in Chapter 47). See also Congressional Record, September 18, 1918, pp. 11, 329. In Porter v. Lederer, 267 Fed. 739, in construing § 209 of the Revenue Act of 1917, it is said: "The mere fact, however, that the profits of a business having no capital are not wholly withdrawn does not make of such undrawn profits a capital fund. Congress has given a clear definition of such capital or capital derived from this source. When, in addition to profits being left undrawn, the fund thus accumulated is 'used or employed in the business,' it is capital within the meaning of the tax law, otherwise it is not."

[18] Revenue Act of 1917, § 209.

[19] Reg. 41, Art. 71.

the Revenue Act of 1918, involves in each case an extensive examination of such business and the manner in which it is conducted. It is beyond the scope of this work to describe at length and in detail the businesses involved in the rulings of the treasury department upon this question. There are stated below, however, certain general principles enunciated by such rulings for guidance in connection with the determination of the question in respect of any particular business.

1. In order to be classed as a concern with nominal capital or as a personal service corporation, the treasury department holds that the income of a corporation must not result in substantial degree from the ownership of property, such as patents.[20] But the courts have assumed a rather more liberal attitude toward this question than the treasury department. In a recent case a corporation originally incorporated with a capital stock of $100,000, which in 1911 had ceased conducting any other business than that of granting licenses under patents owned by it, its capital having been reduced to $10,000 and its surplus in 1917 amounting to $2,000, this capital being used as a fund from which to advance salaries and wages and to provide office furniture and equipment, was held to be a concern with not more than a nominal capital under the 1917 Law. The court held in this case that patents were not capital in an economic sense or in the sense of the phrase "nominal capital."[21]

2. In order to be classed as a concern with nominal capital or as a personal service corporation, an agency acting as selling

[20] T. B. M. 9, T. B. 1-10-135; O. D. 2, T. B. 1-19-5; A. R. R. 363, T. B. 3-21-1394.

[21] De Laski & Thropp Co. v. Iredell, 268 Fed. 377. After referring to the fact that Congress included patents in invested capital to the extent only of investment, and that if there was no investment in them they remained in the same class as that intangible something which makes for the wealth of the professional man or broker, the court said: "The patents which the plaintiff owned were the concrete embodiment of the skill which the plaintiff possessed in its field of activity. This skill or service it bartered for a consideration. Such skill or service is like the service a lawyer in large practice renders for an annual retainer, and is very nearly akin to the service which a commission house renders to those who buy and sell through it, or the service of a concern engaged in selling or leasing real estate, and in writing insurance. The plaintiff's source of income was that which certain persons were willing to pay it for the use of its skill and knowledge. It is true that skill and knowledge had been reduced to concrete form; but the payment was for the use of the skill and knowledge, and not for any part or parcel of the form to which the skill and knowledge had been reduced."

agent must not acquire title to the products handled or be responsible to the manufacturer for the products sold.[22]

3. In order to be classed as a concern with nominal capital or as a personal service corporation, a company in the brokerage commission business must not be liable to the consignor for the selling price of the product sold.[23]

4. In order to be classed as a concern with nominal capital or as a personal service corporation, a commission house or agency must not extend substantial credit to firms for which it acts as agent.[24]

5. Where the income of a concern is to be ascribed to a *combination* of the activities of the principal owners and stockholders and the activities of the managers and various agencies who are not stockholders, the concern will not be entitled to be classed as one with a nominal capital or as a personal service corporation.[25]

The following businesses have been held not to fall within the definition of concerns with a nominal capital or personal service corporations:

1. A freight forwarding business which advances various costs of carriage.[26]

2. A corporation engaged in the business of retailing automobiles, which business is that of the ordinary commercial enterprise in which capital is a material factor in the conduct of the business.[27]

3. A sanitarium owned and operated by doctors which derives income from the buildings and grounds by housing patients.[28]

4. A stevedoring company, financed by a foreign government, the stockholders of which are practically stevedoring efficiency engineers.[29]

A corporation conducting a commercial school, having both home study and resident instruction departments, which does not lodge or board any students, and to which the principal owners give all their time and attention in the preparation of courses,

[22] A. R. M. 42, T. B. 17-20-880; A. R. R. 23, T. B. 6-20-724; A. R. R. 364, T. B. 3-21-1395. The nominal capital of a corporation may be evidence that no responsibility was contemplated (A. R. R. 500, T. B. 21-21-1645).

[23] A. R. R. 23, T. B. 6-20-724.

[24] A. R. R. 50, T. B. 20-20-929; A. R. R. 46, T. B. 13-20-802.

[25] A. R. M. 59, T. B. 26-20-1023. But see A. R. R. 463, T. B. 41-21-1858.

[26] A. R. R. 7, T. B. 29-19-622.

[27] T. B. R. 58, T. B. 19-19-492.

[28] O. D. 2, T. B. 1-19-5.

[29] A. R. R. 463, T. B. 41-21-1858.

syllabus of work, inspection of higher lessons, and settling points in dispute, has been held to be a concern with nominal capital only and a personal service corporation under the Revenue Act of 1918.[30]

Dividends. In the case of personal service corporations the term "dividend" means any distribution made by a personal service corporation to its shareholders or members, whether in cash or in property of the corporation except a distribution out of its earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922.[31] Any distribution is deemed to have been made from earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since March 1, 1913; but any earnings or profits accumulated, or increase in value of property accrued, prior to March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.[32]

Returns. Every personal service corporation must make a return of income, regardless of the amount of its net income. The return should be on Form 1065 (Revised). It should be made for the taxable year of the personal service corporation; that is, for its annual accounting period (fiscal year or calendar year, as the case may be), regardless of the taxable years of its stockholders.[33]

CONTENTS OF RETURN. The return of a personal service corporation should state specifically (a) the items of its gross income; (b) the deductions to which it is entitled; (c) the amounts of dividends from taxable corporations and from personal service corporations out of earnings and profits upon which income tax has been imposed, and from interest upon obligations of the United States and bonds of the War Finance Corporation included in gross income; (d) the amount of any income, war-profits and excess-profits taxes of the personal service corporation paid during the taxable year to a foreign country or to any

30 A. R. R. 24, T. B. 27-27-36.

31 Cf. Revenue Act of 1921, § 201 (a) and Revenue Act of 1918, § 201 (a). The change made in the 1921 Law is, of course, occasioned by the abolition of personal service corporations as of December 31, 1921.

32 Revenue Act of 1921, § 201 (b); Revenue Act of 1918, § 201 (b). See Chapters 17 and 19 in which the application of distributions against and their reduction of the basis provided in § 202 for determining gain or loss is discussed.

33 Reg. 45, Art. 624. If the personal service corporation makes any change in its accounting period, it should render its return in accordance with the provisions of § 226.

possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (e) the amounts distributed by the corporation during its taxable year with the dates of distribution; (f) the names and addresses of the stockholders of the corporation at the close of its taxable year and their respective shares in such corporation; (g) such facts as tend to show whether or not the corporation is a personal service corporation; and (h) such other facts as are required by the form.[34]

Distributive Shares of Stockholders. A stockholder of a personal service corporation is required to include in his gross income for the taxable year (a) any dividends paid by the corporation in such year out of earnings or profits accumulated since February 28, 1913, and before January 1, 1918; (b) his share of any distribution made by the corporation in such year out of earnings or profits accumulated since December 31, 1917, and since the close of its taxable year ending with or during his next preceding taxable year; and (c) his distributive share of the undistributed net income of the corporation for its taxable year ending with or during his taxable year, provided he was at the close of its taxable year a stockholder in the corporation, notwithstanding he might since have ceased to be a stockholder. In the case of personal service corporations with taxable years other than the calendar year, however, such distributive shares or distributions may be subject to different rates of tax.[35] In view of the fact that personal service corporations are not required to file consolidated returns, a profit realized or loss sus-

[34] Reg. 45, Art. 624. This ruling was made under the 1918 Law. Point (c) will be changed under the 1921 Law to dividends from domestic corporations (except those taxable under § 262) and foreign corporations with 50% of their income from sources within the United States, as provided in § 216 (a). In connection with (d) it will be necessary to furnish evidence as to the amount of income derived from sources without the United States and any information necessary for the verification and computation of the credit for taxes. (See § 222 (c).)

[35] Reg. 45, Art. 330. This ruling was made under the 1918 Law. The taxation of stockholders of personal service corporations with fiscal years ending in 1918 and 1919, is discussed in Reg. 45, Arts. 329, 332, 334; O. D. 453, T. B. 15-20-850; O. D. 1101, T. B. 46-21-1922; O. D. 1127, T. B. 49-21-1963. The application of different tax rates in the case of fiscal years of personal service corporations ending in 1918 and 1919 respectively, is discussed in Reg. 45, Arts. 329, 333 and 335. Point (a) will now probably be changed to any such dividends out of earnings or profits accumulated since February 28, 1913, except between January 1, 1918, and December 31, 1921; and Point (b) will probably be changed to any such dividends out of earnings or profits accumulated between January 1, 1918, and December 31, 1921.

tained by a personal service corporation, attributable to its ownership of stock in another personal service corporation, should be accounted for in the same manner as in the case of an individual stockholder. Where the business of a personal service corporation results in an operating loss, such loss will be divided among the stockholders at the close of its taxable year in proportion to their respective shares, and will constitute an allowable deduction in their returns of annual net income.[36]

Credits Allowed Stockholders. A stockholder of a personal service corporation is entitled to credit for the purpose of the normal tax only for amounts received in distribution of earnings or profits of the corporation accumulated since February 28, 1913, and prior to January 1, 1918. He will, of course, also be entitled to a credit for amounts received in distribution of earnings or profits accumulated after December 31, 1921, because from that date the corporation will no longer be taxed as a personal service corporation. In addition to the credits ordinarily allowed to an individual a stockholder of a personal service corporation is entitled to the following credits: (a) A credit against net income for the purpose of the normal tax only of his proportionate share of such dividends and interest as are received by the personal service corporation, and which an individual is entitled to credit against net income for the purpose of the normal tax and (b) a credit against income tax of the stockholder's proportionate share of income, war-profits and excess-profits taxes of the personal service corporation paid or accrued during the taxable year to a foreign country upon income derived from sources therein, or to any possession of the United States.[37]

Procedure in Claiming Personal Service Status. A corporation filing returns on Form 1120 and subsequently desiring to establish its status as a personal service corporation should adopt the following method of procedure:

It should file amended returns on Form 1065 accompanied by a claim for refund on Form 46 for the tax or installments thereof paid. The individual members of the corporation should also file amended returns accompanied with claims in abatement, Form 47, covering the additional assessment shown by such returns. In the event that the corporation is found to be taxable as an ordinary corporation the claim for refund will be disallowed.

[36] O. D. 581, T. B. 28-20-1057.

[37] Reg. 45, Art. 331. See Revenue Act of 1921, § 201, 216. The credit stated in (b) is of course subject to the limitations of § 222 of the statute. See foot note 34.

In case the corporation establishes a personal service status, the claim for refund will be allowed for the tax paid by the corporation, and the claims in abatement will be disallowed and assessment made to the extent of the additional tax shown to be due on the amended individual returns. Where this procedure is adopted, however, the installments of tax which become due prior to determination of the status of the corporation as shown by its return, as originally filed, must be paid on or before the due dates. Such installments are not subject to either abatement or credit, but can only be covered by supplemental claim for refund.[38]

Corporations Formed to Evade the Surtaxes. If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate, instead of being divided or distributed, the stockholders of such corporation will be subject to income tax of 25% or they will be subject to tax in the same manner as the stockholders of a personal service corporation or members of a partnership.[39]

Alternative Retroactive Tax on Personal Service Corporations. It has been contended that certain expressions of the Supreme Court in the stock dividend decision[40] indicate the invalidity of the provisions of the Revenue Act of 1918 dealing with the taxation of the stockholders of personal service corporations and taxing such stockholders upon their distributive, but undistributed, shares of the net income of such corporations. While the treasury department has officially disagreed with this view,[41] Congress has recognized that there is "doubt" as to the "provisions of the Revenue Act which treat personal service corporations substantially as partnerships,"[42] and has provided that if such provisions, and also the corresponding provisions (for 1921) of the Revenue Act of 1921 are by final adjudication declared invalid, there shall, in addition to all other taxes, be levied, collected, and paid on the net income received during the calendar years 1918, 1919, 1920, and 1921, by every personal service cor-

[38] O. D. 614, T. B. 31-20-1103.

[39] Revenue Act of 1921, § 220; Revenue Act of 1918, § 220. For a full discussion of this subject see Chapter 2.

[40] Eisner v. Macomber, 252 U. S. 189. Some of the expressions referred to are indicated in Chapter 2.

[41] O. D. 679, T. B. 41-20-1232.

[42] See Report of Finance Committee on Internal Revenue Bill of 1921, p. 34. The same reasoning occasioned the flat 25% tax imposed by § 220 of the Revenue Act of 1921. (See same report, p. 16.) Some of the expressions referred to are indicated in Chapter 2.

poration, a tax equal to the taxes imposed by Titles II and III of the Revenue Act of 1918 and, in the case of income received during the calendar year 1921, by Titles II and III of the Revenue Act of 1921. In such event every such personal service corporation is required, on or before the 15th day of the 6th month following the date of entry of decree upon such final adjudication, to make a return of any income received during each of the calendar years 1918, 1919, 1920, and 1921 in the manner prescribed by the Revenue Act of 1918 (or in the manner prescribed by the Revenue Act of 1921, in the case of income received during the calendar year 1921). Such return must be made and the net income computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in the manner provided for other corporations under the Revenue Act of 1918 and the Revenue Act of 1921. This alternative tax will be assessed, collected, and paid upon the same basis, in the same manner, and subject to the same provisions of law, including penalties, as the ordinary taxes imposed by the Revenue Act of 1918 (or the Revenue Act of 1921 in the case of income received during the calendar year 1921), but no interest or penalties will be due or payable thereon for any period prior to the date upon which the above return is required to be made and the first installment paid. The tax paid by any shareholder or member of a personal service corporation will be credited against the alternative tax due from such corporation upon the joint written application of such corporation and such shareholder or member or his representatives, heirs, or assigns, if such application is filed with the commissioner within six months from such date of entry of decree.

No credit or refund of taxes paid by any shareholder or member of a personal service corporation will be allowed unless claim therefor is filed within six months from the date of entry of the decree declaring the provisions taxing personal service corporations invalid. If the claims for credit or refund, filed within 6 months from such date of entry of decree, represent less than 30% of the outstanding stock or shares in the corporation, the alternative tax upon such corporation will be reduced to that proportion thereof which the number of stock or shares owned by the shareholders or members making such claims bears to the total number of stock or shares outstanding. A personal service corporation of which no shareholder or member has filed such a claim for credit or refund within such period of six months, will not be subject to the alternative tax discussed in this paragraph.[43]

[43] Revenue Act of 1921, § 1332.

CHAPTER 10

CORPORATIONS

Corporations are taxed as separate entities apart from their stockholders. They were subject, under the Revenue Act of 1918, to a tax of 10% upon their net income for the years 1919 and 1920.[1] Under the Revenue Act of 1921, in lieu of the tax imposed by the 1918 law, they are subject to a tax of 10% for the year 1921, and 12½% for the year 1922 and subsequent years, upon their net income.[2] The rate is increased for 1922 and subsequent years because of the repeal of the excess-profits tax, as of December 31, 1921. Aside from this increase of rate the most important changes made in the present law applying particularly to corporations are (a) the provision that for any taxable year beginning after January 1, 1922, the filing of consolidated returns by affiliated corporations shall be optional with the taxpaying corporation, (b) the provision for the taxation of certain domestic corporations only upon income from "sources within the United States," and (c) the provision for the taxation as corporations of individual or partnership businesses incorporated within four months of the passage of the act.[3] Corporations are not subject to the surtaxes.[4] They are entitled to deduct from their gross income, which (except in the case of insurance companies) is computed in the same manner as the gross income of individuals,[5] the deductions and credits specified in the law,[6] which differ to some extent from the deductions and credits allowed to individuals. Corporations, like individuals, make returns for the calendar or their fiscal year, according to the annual accounting period employed in keeping their books.[7] The mere existence of a corporation during any part of the year is ordinarily sufficient to require

[1] Revenue Act of 1918, § 230. This rate was 12% for the calendar year 1918. This tax was in lieu of the taxes imposed by the 1916 Law, as amended by the 1917 law. (Revenue Act of 1916, § 10.) The total tax to which corporations were subject under the 1916 and the 1917 Laws was 6%. (Revenue Act of 1917, § 4.)

[2] Revenue Act of 1921, § 230.

[3] Revenue Act of 1921, §§ 240, 262, 229. The filing of consolidated returns was obligatory under the 1918 Law.

[4] See Reg. 33, Art. 185. The excess-profits tax is in effect a corporate surtax.

[5] Revenue Act of 1921, § 233; Revenue Act of 1918, § 233.

[6] Revenue Act of 1921, §§ 234, 236; Revenue Act of 1918, §§ 234, 236.

[7] Revenue Act of 1921, §§ 200, 232; Revenue Act of 1918, §§ 200, 232.

it to make a return.[8] Prior to the 1918 law, the mere receipt of net income from any source made it liable for the tax, but it may now be in receipt of net income without being liable for the income tax if the credits to which it is entitled equal or exceed such net income.[9] Thus, a corporation may be in receipt of net income not in excess of $2,000 and be entitled to a credit of $2,000 against such net income for the purpose of the income tax, as a result of which it will be in receipt of net income without being liable for the income tax. Since the tax is an income tax and not an excise tax,[10] doing business is not a necessary element of taxability.[11] The special provisions of the law applicable only to insurance companies are discussed in another chapter.[12]

Definition. The tax is imposed on every corporation, domestic or foreign. The word "corporation" is used in this chapter as defined in both the 1918 and the present law,[13] and includes associations, joint-stock companies, and insurance companies. The rulings under the 1918 law in definition of corporations will, therefore, be applicable under the present law.

JOINT-STOCK COMPANIES AND ASSOCIATIONS.[14] There seems to be no constitutional or legal objection to including joint-stock

[8] See page 245.

[9] Revenue Act of 1921, §§ 234, 236; Revenue Act of 1918, §§ 234, 236.

[10] The tax assessed on corporations for the months of January and February, 1913, under the 1913 Law, was an excise tax and not an income tax and, therefore, applied only to corporations "doing business," but the exemptions and deductions to which a corporation was entitled were those allowed by the 1913 Law, which law did not permit the deduction of dividends. (Butterick Company v. U. S., 240 Fed. 539.)

[11] The numerous cases under the 1909 Law holding certain corporations not to be taxable on the ground that they were not "doing business" have no application to the *income tax* laws.

[12] See Chapter 11.

[13] Revenue Act of 1918, § 1; Revenue Act of 1921, § 2. As used in the regulations issued under the 1916 law, the term "corporation" was construed to include all corporations, joint-stock companies and associations, and all insurance companies coming within the terms of the law as well as all business trusts organized or created for the purpose of engaging in commercial or industrial enterprises, the capital of which was evidenced by certificates or shares of interest issued or issuable to members on the basis of which profits were distributed or distributable. (Reg. 33 Rev., Art. 57.)

[14] The 1909 Law taxed "Every corporation, joint-stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any state or territory of the United States or under the acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any state or territory of the United States or in Alaska or in the District of Columbia." (Act of August 5,

companies in the same category with corporations.[15] A joint-stock company organized pursuant to the New York Joint-Stock Association Law was held, under the 1909 law, to be practically a "corporation," despite the absence of the important corporate attribute of limited liability, and was held taxable as such.[16] By regulation issued under the 1918 law, it is provided that the terms "joint-stock companies" and "associations" include associations, common-law trusts, or organizations by whatever name known which act or do business in an organized capacity, whether created under and pursuant to state laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds, or where there is no capital stock, on the basis of the proportionate share or capital which each has, or has invested, in the business or prop-

1909, § 38.) The 1913 Law taxed "Every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships." (Act of October 3, 1913, § G (a).) The 1916 Law taxed "Every corporation, joint-stock company or association, or insurance company organized in the United States, no matter how created or organized but not including partnerships." (Revenue Act of 1916, § 10 (a).) The present law and the 1918 Law tax every corporation and define the term "corporation" to include "associations, joint-stock companies, and insurance companies." (Revenue Act of 1921, § 2; Revenue Act of 1918, § 1, 230.) It will be noted that the phrase "no matter how created or organized" used in both the 1913 and 1916 Laws is omitted from the definition of corporation contained in the 1918 and the present law. On the other hand, the phrase "joint-stock company or association" (between commas) has been changed to "associations, joint-stock companies." The purpose of this transposition is to separate the word "associations" from any limitation imposed by conjunction with the word "joint-stock" and to use it to cover organizations which can not be included within the terms "corporations," "joint-stock companies," or "insurance companies." The phrase "no matter how created or organized" seems to have been aimed to include organizations not "organized *under the laws* of the United States or of any state * * *" which were held not liable to tax under the 1909 Law, in view of the language of that act. They apply not only to insurance companies, but relate back to the words "every corporation, joint-stock company or association," so that what is meant is that all such concerns (not including partnerships) are included and are taxable. See Crocker v. Malley, 249 U. S. 223; Eliot v. Freeman, 220 U. S. 178; T. D. 2418; Chicago T. and T. Co. v. Smietanka, 275 Fed. 60; T. D. 3193, T. B. 20-21-1741; A. R. R. 652, T. B. 15-21-1902; Reg. 38 Rev., Art. 2, General Instructions 3.

15 See Spreckels Sugar Refining Co. v. McClain, 192 U. S. 397; Flint v. Stone Tracy Co., 220 U. S. 107.

16 Roberts v. Anderson, 226 Fed. 7.

erty of the organization.[17] An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership.[18]

It has been held under the 1913 law that an organization, in form a trust, created by an *agreement* of the stockholders of several street railway corporations desiring to effect a unitary control of the properties of such corporations is an association, where the agreement uses language that reads much like the state corporation law, and superimposes that organization upon the several corporations by placing the legal title to the capital stock of those corporations in the trustees named, who are to do certain specified things only, and by providing for a committee which controls even the power of the trustees to vote the capital stock of the corporations, and which is elected and controlled by what are called participating shareholders, who hold certificates of common and preferred participating shares issued by the trustees in lieu of the capital stocks of the corporations.[19] A mining partnership, within the meaning of the laws of Colorado, has no *delectus personarum* and is not dissolved by the withdrawal, death, or bankruptcy of a member; a member's interest therein may be sold; a majority in interest may bind the partnership. As has been said of an Idaho mining partnership, it is "in all essential elements * * * precisely like a corporation".[20] Such a partnership is, therefore, taxable as an association, even though formed independently of any statute.[21] Where after the expiration of the charter of a corporation, by limitation, its business is continued in the corporate form, the organization so conducting the business is an "association".[22]

Pooling of Corporate Stock. Where the holders of the entire common stock of a corporation agree to pool their stock interests and share in a certain portion of the profits accruing to the corporation according to a fixed arbitrary percentage rather than in proportion to their respective stock holdings,

17 Reg. 45, Art 1502; Reg. 33 Rev., Art. 58; Reg. 33, Art, 79. See Chicago T. & T. Co. v. Smietanka, 275 Fed. 60; T. D. 3193, T. B. 20-21-1741.

18 Reg. 45, Art. 1503.

19 Chicago T. & T. Co. v. Smietanka, 275 Fed. 60; T. D. 3193, T. B. 30-21-1741.

20 Hawkins v. Spokane Hydraulic Co., 3 Idaho 650, 33 Pac. 40.

21 A. R. R. 652, T. B. 45-21-1902.

22 Sol. Op. 93, T. B. 14-21-1552.

the corporation is still taxable as such and is not to be treated as a partnership for purposes of the income tax.[23]

"SYNDICATES." Where a block of securities is purchased in joint account by several corporations, partnerships or individuals for the purpose of disposing of them to the public through the syndicate managers, the only obligation of the members of the syndicate being to take and pay for the portion of the securities not disposed of, such temporary combinations of business interests are neither corporations, joint-stock companies or associations, nor partnerships, and the profits of the syndicate are not taxable in the hands of the syndicate. The several members pay the tax on their respective shares of the profit of the transaction.[24] Where the property of a dissolved corporation is transferred to trustees for the benefit of a newly formed syndicate consisting of the trustees and two other persons, and all the stockholders of the dissolved corporation receive transferable certificates of interest in the syndicate in the same proportion that they had held stock in the corporation, the purpose of the agreement being to preserve the ownership of the real estate of the corporation until it can be sold on reasonable terms, it has been held that the organization effected constitutes an "association", and not a "partnership", "trust" or "joint venture". In this case a majority in interest controlled the management and sale of the property. Distribution to the shareholders of the profits and assets upon dissolution was provided for. At the end of 10 years, an undivided interest in all property of the syndicate was to be conveyed to the members as their interests appear at that time. The death of any one or more of the members could not work a dissolution of the syndicate.[25]

TRUSTS NOT TAXABLE AS ASSOCIATIONS. In a case arising under the 1913 law a Maine corporation with eight shareholders had its mills in Massachusetts and owned outlying land. The Maine corporation conveyed to a Massachusetts corporation formed in 1912 seven mills and let to it an eighth that was in the process of construction, together with the outlying lands and tenements, on a long lease, receiving the stock of the Massachusetts corporation in return. The Maine corporation then transferred to the plaintiffs as trustees the fee of the property subject to the lease, left the Massachusetts stock in their hands, and was dissolved. By the declaration of trust the plaintiffs

[23] S. 1001, T. B. 4-19-227.

[24] Letter from treasury department dated February 25, 1914.

[25] O. D. 896, T. B. 18-21-1603.

declared that they held the real estate and all other property at any time received by them thereunder, subject to the provisions thereof, "for the benefit of the *cestui que trusts* (who shall be trust beneficiaries only, without partnership, associate, or other relations whatever *inter sese*)" upon trust to convert the same into money and distribute the net proceeds to the persons then holding the trustees' receipt certificates—the time of distribution being left to the discretion of the trustees, but not to be postponed beyond the end of twenty years after the death of the specified persons then living. In the meantime the trustees were to have the powers of owners, were to distribute what they determined to be fairly distributable net income according to the interests of the *cestuis que trust,* but could apply any funds in their hands for the repair or development of the property held by them, or the acquisition of other property, pending conversion and distribution. A consent of a majority in interest of the *cestuis que trust* was required for the filling of a vacancy among the trustees, for a modification of the terms of the trust, or for any increase over the stipulated fee of the trustees. In no other matter had the beneficiaries any control. The court held that (1) the declaration of trust was an ordinary real estate trust of the kind familiar in Massachusetts in spite of the fact that the trustees' receipt provided that the holder had no interest in any specific property and that it purported only to declare the holder entitled to a certain fraction of the net proceeds of the property when converted into cash "and meantime to income," and in spite of the fact that the trustees held (although not pursuant to the declaration of trust) stock of the Massachusetts corporation and collected dividends upon it; (2) the function of the trustees was not to manage the mills but simply to collect the rents and income from such property as might be in their hands, with a large discretion in the application of it, but with a recognition that the receipt holders were entitled to it, subject to the exercise of the powers confided to the trustees; (3) that the trust would not fall under any familiar conception of a joint-stock association, "whether formed under a statute or not"; (4) the trustees by themselves could not be a joint-stock association, and there was no ground for grouping the trustees and beneficiaries together; (5) the result was not affected by any technical analysis of the individual receipt holder's rights in the income received by the trustees; and (6) the statute failed to show a clear intent to subject the trust to tax as an association or the trustees or

receipt holders to extra tax upon the dividends of the Massachusetts corporation.[26]

The treasury department, in deciding whether a given organization constitutes a "trust" or an "association," now treats the question whether the *cestui que trust* or beneficiaries have a voice in the conduct of the business as the decisive test.[27] If this control is "substantial," an association is held to exist; otherwise a mere trust. In the former event the so-called trust thus held to be an "association" is treated as a distinct entity equivalent to a corporation. Ordinary distributions of income by the trustees are regarded as dividends and as liable only to the surtaxes, the association itself being liable to the corporate income and excess-profits taxes.[28] If the organization in question is held to be a "trust" as distinguished from an "association", its income is treated in the manner more fully described in another

[26] Crocker v. Malley, 249 U. S. 223, reversing 250 Fed. 817. The court said in part: "We do not see either that the result is affected by any technical analysis of the individual receipt holder's rights in the income received by the trustees. The description most in accord with what has been the practice would be that, as the receipts declare, the holders, until distribution of the capital, were entitled to the income of the fund subject to an unexercised power in the trustees in their reasonable discretition to divert it to the improvement of the capital. But even if it were said that the receipt holders were not entitled to the income as such until they got it, we do not discern how that would turn them into a joint-stock company. Moreover the receipt holders did get it and the question is what portion it was the duty of the trustees to withhold. We presume that the taxation of corporations and joint-stock companies upon dividends of corporations that themselves pay the income tax was for the purpose of discouraging combinations of the kind now in disfavor, by which a corporation holds controlling interests in other corporations which in their turn may control others, and so on, and in this way concentrates a power that is disapproved. There is nothing of that sort here. Upon the whole case we are of opinion that the statute fails to show a clear intent to subject the dividends on the Massachusetts corporation's stock to the extra tax imposed by G. (a)." (See also Reg. 45, Art. 1504.)

[27] Crocker v. Malley, 249 U. S. 223; Reg. 45, Art. 1504; S. 1337, T. B. 9-20-762; S. 1068, T. B. 10-19-351; S. 1205, T. B. 27-19-600; O. D. 598, T. B. 30-20-1083; O. D. 407, T. B. 9-20-763; O. D. 236, T. B. 13-19-414; Sol. Op. 56, T. B. 36-20-1177; O. D. 654, T. B. 36-20-1178; O. D. 896, T. B. 18-21-1603; O. D. 868, T. B. 15-21-1557; O. D. 931, T. B. 22-21-1658; O. D. 886, T. B. 17-21-1587.

[28] As an association the organization would be subject also to the capital stock tax imposed by Title X of the present law and the 1918 Law. This subject is treated more fully in Chapter 44. Dealings in the shares or certificates of a so-called trust are subject to the stamp taxes imposed by Title XI, Schedule A, of the present law and the 1918 Law. This subject is also treated more fully in Chapter 45.

chapter.[29] The question whether a particular organization is to be classed as a "trust" or "association" involves in each case a minute examination of the terms of the instrument creating the so-called trust and the rights of the parties to such instrument. It is deemed inadvisable to repeat at length and in detail the provisions of the instruments involved in numerous rulings which have been made by the treasury department upon this point, but there are stated below general principles enunciated by such rulings for guidance in connection with the determination of the question in respect of any particular instrument:

1. It is the extent of the control *vested* in beneficiaries under a trust agreement rather than the extent to which such control is *exercised* that is determinative of the question whether the trust is, in fact, an "association".[30]

2. If the beneficiaries or shareholders have the right under the trust agreement to elect trustees annually, the trust constitutes an "association"; on the other hand, if the trustees appointed by the instrument are to hold office during the entire period of the trust, the right of the beneficiaries or shareholders being limited to filling vacancies, such beneficiaries or shareholders not retaining any substantial control over the affairs of the trust, the trust instrument creates a "trust" and not an association.[31]

3. The power to increase capital stock, advise trustees as to the management of the business, and amend or terminate the trust may likewise cause an organization to be treated as an association.[32]

4. The reservation to the beneficiaries or shareholders of the right to direct and approve the terms of sale of the trust property will constitute the trust an "association".[33]

5. A provision authorizing the trustee or trustees to call upon the beneficiaries or shareholders to pay certain items, such as costs, fees and expenses, in the event that the income of the trust is insufficient, will constitute the trust an "association".[34]

[29] See Chapter 6.

[30] O. D. 407, T. B. 9-20-763.

[31] S. 1068, T. B. 10-19-351; O. D. 620, T. B. 32-20-1112; S. 1337, T. B. 9-20-762; O. D. 868, T. B. 15-21-1557; O. D. 931, T. B. 22-21-1658; O. D. 790, T. B. 6-21-1425.

[32] O. D. 868, T. B. 15-21-1557. It may be doubted whether the power merely to "*advise*" should be given such an effect unless acceptance of advice given be imperative upon the trustees.

[33] O. D. 598, T. B. 30-20-1083; Sol. Op. 49, T. B. 39-20-1208.

[34] O. D. 598, T. B. 30-20-1083; S. 1205, T. B. 27-19-600.

6. Where an agreement between a reorganization committee and the bondholders of a company gives power (a) to the bondholders to terminate the trust (this alone is not sufficient); (b) to terminate the authority of the committee to continue business operations, and (c) to fill vacancies in the committee if dissatisfied with the committee's choice, the agreement has been held to create an "association".[35]

7. If the trustee is given absolute control over the affairs of the trust, in other words, if the trustee is given all the rights and powers which would be his if he were conducting a business of which he was the sole owner, the instrument creates a mere "trust" and not an "association."[36]

8. Where a majority in amount of the shares of beneficial interest in the trust are owned by the trustees as beneficiaries so that to the extent of such ownership the trustees and beneficiaries or shareholders are identical, the beneficiaries are held in fact to control the trustees, even though no control is vested in such beneficiaries under the terms of the trust instrument.[37]

9. A given organization may be a "trust" for part of the year and an association for part of the year. This may happen where the trustees become the holders of a majority interest or divest themselves of such majority interest; or it may happen when the instrument is amended. In such cases separate returns should be made for the two parts of the year, according to the character of the organization.[38]

LIMITED PARTNERSHIPS AND PRIVATE BANKS. This subject is discussed in another chapter.[39] A private bank owned by an individual is not an "association."

DE FACTO CORPORATIONS. Where articles of incorporation are filed under the laws of Kentucky and business is transacted in the corporate name, a return of income received from such business should be rendered for the corporation although its organization as a corporation has not been perfected in the manner required by law. But the rule would be different if no articles of incorporation were filed and the corporation had no *de facto* existence.[40]

[35] Sol. Op. 49, T. B. 39-20-1208.

[36] O. D. 620, T. B. 32-20-1112.

[37] Sol. Op. 56, T. B. 36-20-1177; O. D. 654, T. B. 36-20-1178; O. D. 886, T. B. 17-21-1587.

[38] O. D. 886, T. B. 17-21-1587.

[39] See Chapter 8.

[40] S. 972, T. B. 2-19-168; O. D. 1016, T. B. 35-21-1796; O. D. 1078, T. B. 43-21-1887.

If the charter board of a state declared the charter of a corporation forfeited but the corporation had no notice of such action and continued to do business for a number of years as a corporation and made returns to the federal government accordingly, the corporation can not now set up the action of the charter board to negative its corporate existence. Until the company surrenders its charter to and the same is annulled by the state, or the charter is annulled in some other manner and the company ceases to operate as a corporation, it must be held to be a corporation for income and profits tax purposes.[41]

Where a single stockholder acquires all of the stock in a corporation organized and existing under the laws of Ohio, and thereafter carries on the business in the corporate name and with corporate property, the corporation is not thereby dissolved, even though under the statutes of Ohio a corporation cannot be organized with less than five stockholders and directors, and the corporation should be required to file returns as a *de facto* corporation.[42]

Incorporation of Individual or Partnership Business. The Revenue Act of 1921 contains a new provision that in the case of the organization as a corporation within four months after its passage of any trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed profits or earnings of such trade or business shall not be subject to the surtaxes, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to

[41] O. D. 365, T. B. 2-20-677.

[42] Sol. Op. 91, T. B. 12-21-1524; Society v. City of Cleveland, 43 O. S. 481, 3 N. E. 357 (as to when a corporation is dissolved, and as to whether it can exercise corporation functions when it was not legally constituted); Parker v. Bethel Co., 96 Tenn. 252; 34 S. W. 209, 31 L. R. A. 706; Main v. Mills, Fed. Cas. No. 8974; Ulmer v. Luna Rock Co. (Me.), 66 L. R. A. 387, 98 Me. 579; 57 Atl. 1001. This is another application of the frequently cited principle that a corporation is an entity irrespective of the persons who own its stock (see page 219) a view consistently adhered to by the treasury department.

corporations shall so far as practicable apply to such trade or business. This provision does not apply to any trade or business, the net income of which for the taxable year 1921 was less than 20% of its invested capital for such year. Any taxpayer who takes advantage of this provision must pay the capital stock tax imposed by the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921.[43]

Doctrine of Corporate Entity. Nothing is more conclusively established than the proposition that a corporation will be looked upon as a legal entity entirely distinct from those who own and control it. This general rule is one of the fundamental theories of corporation law and has been firmly embedded in the common law of this country ever since the celebrated opinion of Chief Justice Marshall in the Dartmouth College case.[44] It has been consistently recognized by both state and federal courts.[45] The same position has been uniformly taken by the bureau of internal revenue except in so far as statutory provisions compel otherwise.[46] The doctrine has been restated in emphatic terms by the Supreme Court in a widely discussed case[47] as follows: "We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from

[43] Revenue Act of 1921, § 229. Compare this section with § 330 of the revenue act of 1918, and see the discussion of that section in Chapter 43.

[44] Dartmouth College v. Woodward, 4 Wheat. 518, 636.

[45] Peterson v. Chicago, Rock Island & Pac. Ry., 205 U. S. 364; Conley v. Mathieson Alkali Works, 190 U. S. 406, 409; Pullman Co. v. Missouri Pacific Co., 115 U. S. 587, 597; Oregon Ry. Co. v. Oregonian Ry. Co., 130 U. S. 1; U. S. v. Nipissing Mines Co., 206 Fed. 431, appeal dismissed in 234 U. S. 765; Peo. v. Amer. Bell Tel. Co., 117 N. Y. 241, 22 N. E. 1057.

[46] See L. O. 1062, T. B. 14-21-1548. For instance, the provisions for consolidated returns by affiliated corporations (Revenue Act of 1918, § 240) constitute a statutory exception to the common law doctrine of corporate entity.

[47] Eisner v. Macomber, 252 U. S. 189.

the stockholder, not only because such is the practical fact, but because it is that any dividend—even one paid in money or property—can be regarded as income of the stockholder". The same reasoning has been emphasized very recently in two of the latest cases decided by the Supreme Court.[48] In spite of these decisions the "power or duty of a court to look through the form of a corporation", clearly recognized by the Supreme Court, raises some of the most serious questions presented by the income tax. Many questions arising under the law turn on the recognition of the separate entity of a corporation, and the extent to which the courts will respect the "substantial difference between corporation and stockholder". In some instances the distinction between corporation and stockholder has been ignored in favor of the "substance" and "practical purposes".[50] While it may be true that cases in which this distinction has been ignored turn on their "very peculiar facts", as stated by the court, substantially the same peculiar facts, indeed, facts involving the same controlling principle, would determine the decision in another case. It will not do to dismiss the cases with a statement that they "involve no departure from the doctrine that a corporation and its stockholders are to be regarded as separate and distinct for all purposes including taxation".[51]

They do not overrule the doctrine, but they define situations in which the doctrine will not be applied. They establish the point that the doctrine is not of universal application; they are exceptions to it. The doctrine is too well established for any general disaffirmance; the important consideration is its

[48] U. S. v. Phellis, 42 Sup. Ct. Rep. 63; Rockefeller v. U. S.; New York Trust Co. v. Edwards, 42 Sup. Ct. Rep. 68.

[49] For instance, the deductibility of a loss has depended upon the answer to this question (L. O. 1062, T. B. 14-21-1548). Many questions of gain or loss in connection with the organization and reorganization of corporations turn upon the same point (See Chapter 17). Indeed, in these cases the very definition of the term "income," as used in the Sixteenth Amendment, is involved, as it was also in the stock dividend case (Eisner v. Macomber, 252 U. S. 189). The residence of corporations and the distinction between domestic and foreign corporations often depends upon the same doctrine (see paragraphs supra and Chapter 12). The point arises in connection with the requirement that all corporations must file returns. whether or not they receive income (See paragraph on Returns, Post). It is unnecessary to enumerate the many viewpoints from which the point is important; it arises in several connections throughout this volume.

[50] Southern Pacific Co. v. Lowe, 247 U. S. 330; Gulf Oil Corp. v. Lewellyn, 248 U. S. 71; distinguished in Walker v. Gulf & Interstate Co., 269 Fed. 885. See Anderson v. Morris & Essex Railroad Co., 216 Fed. 83.

[51] See L. O. 1062, T. B. 14-21-1548.

scope and applicability. If it is not to be applied in all cases, and this must be admitted, when will it be applied and when will it be disregarded? This question is of the utmost importance in connection with the income tax, and for this reason the facts of the cases in which separate corporations were regarded as "merged" are given somewhat at length.

Where a subsidiary company kept no bank account, but its earnings were deposited in the bank account of the parent company, which advanced the necessary funds whenever needed by the subsidiary for any operating expenses, or for additions or betterments, it was held that dividends, received by the controlling company and declared and paid during the first six months of 1914 out of surplus of the subsidiary company accumulated prior to January 1, 1913, and on such date consisting principally of a debit on the books of the subsidiary company, kept in accordance with the lease under which the controlling company operated the subsidiary company, were not taxable as income received in 1914 by the controlling company. It was also held that the time of the declaration or payment of the dividends was immaterial; that the declaration and payment thereof was a paper transaction to bring the books into accord with the acknowledged rights of the controlling company; that such dividends bore the appearance of accruing and in form only accrued to the controlling company after January 1, 1913; that, prior to such date, while the two companies were separate legal entities, yet in fact and for all practical purposes they were merged and identical, the subsidiary company being but a part of the controlling company, acting merely as its agent and subject in all things to its direction and control, the funds in question being in the actual possession and control of the holding company as well before as after the declaration.[52]

Where a holding company, owning all the stock in several subsidiary companies, except the qualifying shares held by directors, which holding company and subsidiary companies constituted and were related as parts of a single enterprise of buying, transporting, refining and selling oil and which subsidiary companies had retained their earnings although making some loans *inter sese* and had invested in properties all their funds which were not actually required to carry on the business so that the debtor companies had no money to pay their debts, decided in January, 1913, to take over the previously accumulated earnings and sur-

[52] Southern Pacific Co. v. Lowe, 247 U. S. 330, distinguished in Walker v. Gulf & Interstate Co., 269 Fed. 885.

plus of such subsidiaries and actually did so in 1913 by votes of the subsidiaries, the court disregarded the forms gone through and the distinct corporate entities, and considered only the result, which was that the holding company became the holder of the debts previously due from one subsidiary to another, was no richer than before, but its property, formerly represented only by stock in the subsidiaries, was thereafter represented by stock in *and debts due from* such subsidiaries. The changes having been effected by entries on the respective companies' books, the transaction was held to be a bookkeeping transaction and not a declaration and payment of dividends in the ordinary course by the subsidiaries. Although the holding company *did not itself do the business of the subsidiaries and have possession of their property,* the court nevertheless followed the principle of the case last discussed.[53]

The above cases, arising under previous income tax laws, establish the principle that corporate form *may* be disregarded under unusual circumstances. The courts have stated that this will be done (1) when necessary to circumvent fraud and (2) when a corporation is so organized and controlled as to make it merely an instrumentality or adjunct of another corporation for a sinister or wrongful purpose or to work injustice.[54] This definition of the exceptions to the rule of separate corporate entity, taken in connection with another statement quoted below, probably furnishes the best guide possible in determining the applicability of the general doctrine that a corporation is separate and distinct from those who own and control it. The statement referred to is as follows:[55]

[53] Gulf Oil Corporation v. Lewellyn, 248 U. S. 71, distinguished in Walker v. Gulf & Interstate Co., 269 Fed. 885.

[54] Pittsburg & Buffalo Co. v. Duncan, 232 Fed. 584; in re Watertown Paper Co., 169 Fed. 252.

[55] See U. S. v. Milwaukee Co., 142 Fed. 247. While most of the exceptions to the general rule of separate corporate existence involve the element of fraud, it can not be generally asserted that the existence of fraud is necessary to constitute an exception. The cases turn on their peculiar facts and it is difficult to formulate any general classification of the exceptions.

A few of the many cases are indicated below on both sides of the question, viz., cases wherein corporate entity has been *respected* and cases wherein it has been *ignored*:

(1) *Cases wherein corporate entity has been ignored*:

(a) *Bankruptcy Cases*:

In re *Muncie Pulp Co.*, 139 Fed. 546, on the ground that the corporation was a mere agent of another corporation;

In re *Rieger, Kapner & Altmark*, 157 Fed. 609, on the ground that the corporation was merely the agency of a partnership.

In re *Horgan*, 97 Fed. 319, on the ground that the corporation was a mere fiction;

(b) *Patent Cases*:

Nat Co. v. Connecticut Co., 73 Fed. 491, on the ground (a) that the corporation was a mere cover for the transaction of an individual's business, (b) the relation between the corporation and an individual was such as to impute estoppel against the individual to the corporation, or (c) that the corporation was not in a position to be heard in a court of equity;

(c) *Cases of vicarious liability imposed upon one corporation because of stock ownership in or control of corporation primarily liable*:

Chicago Mill, etc., Co. v. Boatman's Bank, 234 Fed. 41, on the ground (a) that the corporation was a department of the business of another corporation held liable, or (b) was its *alter ego;*

Searchlight Co. v. American Co., 240 Fed. 745, on the ground that the separate entity of the corporation was being made use of for the purpose of evading responsibility, as a means of distorting or hiding the truth or covering up transactions;

Interstate Co. v. Baltimore & O. Co., 51 Fed. 49, on the mixed ground that the corporation was the agent of another corporation and was a mere name under which the other transacted its business;

Lehigh Valley R. Co. v. Delachesa, 145 Fed. 617, on the ground that the relationship of principal and agent existed;

O'Brien v. Champlain Co., 107 Fed. 338, on the ground that the corporation was a myth;

(d) *Federal Court Jurisdiction Cases*:

Miller & Lux v. East Side Co., 211 U. S. 293, on the ground that the corporation was an agent of another corporation established for purpose of conferring jurisdiction on federal courts, through diversity of citizenship;

(e) *Criminal Cases*:

Southern Co. v. Interstate Commerce Commission, 219 U. S. 497, on the ground that the corporations were directed by the same paramount and continuing power and made single by it;

U. S. v. Lehigh Valley Co., 220 U. S. 254, on the ground that the corporation was but an agency, dependency or department of a carrier;

(f) *Miscellaneous*:

Amer. Nat. Bank v. Nat. Co., 77 Fed. 85, on the ground that the corporation was being used by another corporation as a scapegoat for its debts;

Colonial Trust Co. v. Montello Works, 172 Fed. 310, on the ground that the corporation was especially organized agency of another corporation;

(2) *Cases wherein corporate entity has been respected:*

Victor Co. v. American Co., 189 Fed. 359 (patent case);

Hall's Safe Co. v. Herring, etc., Co., 146 Fed. 37 (unfair trade case);

"A corporation, from one point of view, may be considered an entity, without regard to its shareholders, yet the fact remains self-evident that it is not in reality a person or thing distinct from its consistent parts. The word corporation is but a collective name for the members who compose the association. (Citing cases.) If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons. This much may be expressed without approving the theory that the legal entity is a fiction, or a mere mental creation; or that the idea of invisibility or intangibility is a sophism. A corporation, as expressive of legal rights and powers, is no more fictitious or intangible than a man's right to his own home or his own liberty."

Residence. A domestic corporation is one organized or created in the United States including only the states, the territories of Alaska and Hawaii and the District of Columbia.[56] With one exception domestic corporations are considered to be residents of this country, wherever their property or their business is located and whether or not they do business within or without this country, and are taxable regardless of the fact that they may derive all of their income from sources outside of the United States,[57]

Richmond Co. v. Richmond Co., 68 Fed. 105 (case of vicarious liability);
East St. Louis Ry. Co. v. Jarvis, 92 Fed. 735 (case of vicarious liability);
Conley v. Mathieson Works, 190 U. S. 406, 205 U. S. 392 (case of "doing business");
Federal Mining Co. v. Bunker Hill Co., 187 Fed. 474 (federal court jurisdiction case);
Peterson v. Chicago, etc., Co., 205 U. S. 362 (process case);
United Mines Co. v. Hatcher, 79 Fed. 517 (statutory lien case);
Crane & Co. v. Fry, 126 Fed. 278;
U. S. v. Union Stockyard Co., 192 Fed. 330 (criminal case);
Jenks v. Brewster, 96 Fed. 625.

[56] Revenue Act of 1921, § 2; Revenue Act of 1918, § 1. A corporation receiving a charter from the United States Court for China and holding itself out to be a corporation under the laws of the United States will, under the Revenue Act of 1918, be considered a domestic corporation. (O. D. 661, T. B. 38-20-1199.)

[57] This definition follows the American theory that a corporation can not migrate but must remain a resident of the jurisdiction in which it is created. See Chapter 12. In a case under the 1909 Law payment of the tax was

and have no resident stockholders. They are a distinct artificial entity domiciled in the state or jurisdiction pursuant to the law of which they are organized or created.

The exception referred to is a new class of domestic corporation created by the Revenue Act of 1921, consisting of domestic corporations—(a) 80% or more of the gross income of which for a three-year period preceding the close of the taxable period was derived from sources within a possession of the United States, and (b) 50% or more of the gross income of which for such three-year period was derived from the active conduct of a trade or business within a possession of the United States, all as is more fully indicated in another chapter. Such corporations are treated as foreign corporations; and they are taxable only on income from sources within this country.[59] Dividends paid by them may not be credited for purposes of the normal tax and deducted by other corporations.[60] Neither are dividends paid by them income from sources within the United States when received by nonresident aliens and foreign corporations.[61]

Although domestic corporations, other than those just described, are taxable from whatever place their income is derived, and in whatever jurisdiction their business and property is located and stockholders reside, within certain limitations they are entitled to credit against the tax due taxes paid to any foreign country or possession of the United States.[58]

Other Corporations Engaged in Business in Porto Rico and the Philippines. The 1918 law provided that in Porto Rico and the Philippines the income tax should be assessed and collected under the Revenue Act of 1916, as amended, but gave the respective legislatures of these possessions power to amend, alter, modify, or repeal the income tax laws in force therein.[62] The present law reserves the same power to amend, alter, modify, or repeal, and provides that the income tax shall be assessed and collected in Porto Rico and the Philippines "as provided by law

refused, the corporation claiming that because its business was transacted in a foreign country and it had no assets in this country, its stockholders living in the foreign country and its income being spent and invested there it was not liable for the tax assessed. The treasury department proposed to test the question but after the institution of suit the company abandoned its position and made payment covering the tax and penalties, the action being thereupon discontinued. (T. D. 1863.)

58 Revenue Act of 1921, § 238.

59 Revenue Act of 1921, § 262.

60 Revenue Act of 1921, §§ 216, 234 (a) 6.

61 Revenue Act of 1921, § 217.

62 Revenue Act of 1918, § 261.

prior to the passage of this act (November 23, 1921)."[63] The legislatures of Porto Rico and the Philippines repealed the 1916 Law, as amended, on March 7, 1919, and July 26, 1919, respectively, passing other acts in lieu thereof.[64]

A United States corporation which derives income from sources within Porto Rico, a Porto Rican corporation which derives income from sources within the United States, and a corporation of a foreign country which derives income both from sources within Porto Rico and from sources within the United States, are all taxed in both places. In the case of the United States corporation the income and excess-profits taxes in the United States are credited with the amount of any income and excess-profits taxes paid in Porto Rico. In the case of the Porto Rican corporation there is no such credit. The corporation of the foreign country deriving income from both places is subject to no double taxation so far as the United States and Porto Rico are concerned. The same principles apply in the case of the Philippine Islands.[65]

Gross Income. Corporations are subject to tax on income received from all sources, including gains, profits and income derived from trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of ownership or use of or interest in such property; and also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income from any source whatever, except exempt income, which is not to be included in gross income, as provided in the statute.[66]

63 Revenue Act of 1921, § 261.

64 See The Income Tax Law of Porto Rico, Laws of Porto Rico, § 77; An Act Establishing the Income Tax, Laws of the Philippines, § 20; Reg. 45, Art 1131, as revised January 28, 1921.

65 But, under the 1921 law, a United States corporation which derives income from sources within Porto Rico or the Philippines may be taxed in the United States only with respect to income from sources in the United States (See Revenue Act of 1921, Sec. 262). Reg. 45, Art. 1133, as revised January 28, 1921; O. 976, T. B. 1-20-663. A corporation organized in the United States is subject to the 4 per cent. war income tax imposed by the Revenue Act of 1917, even though it has its principal office, keeps its accounts, and does all of its business in Porto Rico and derives all of its income from sources therein. Such a corporation should file its return in the district where its principal office in the United States is located. (L. O. 1066, T. B. 25-21-1694.)

66 Revenue Act of 1921, §§ 213 (b), 233 (a); Revenue Act of 1918, §§ 213 (b), 233 (a). The income so exempted from tax is fully discussed in Ch. 14, and it is deemed unnecessary to describe this income at this point. Some of the classes of exempt income obviously have no application to cor-

Gross income includes items subject to the excess-profits tax as well as income tax, but for the purpose of the latter these items are credited against the net income.[67] Where a corporation is engaged in carrying on more than one class of business, the gross income derived from the different classes is ascertained according to the rules applicable thereto and the gross income of all the classes of business in which the corporation is engaged is taken to be the gross income of the corporation. Thus, the gross income of manufacturing companies consists of the total sales of manufactured goods during the year, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year; and mercantile companies proceed similarly in determining their gross income by inventory, adding in each case the income from all other sources.[68] The general provisions as to income applicable both to corporations and individuals are discussed in the succeeding chapters on income[69] and only the special provisions applicable to corporations are referred to in this chapter. Not all receipts by a corporation are income, as is indicated in the following paragraphs. Except where otherwise indicated the rulings issued under the 1918 Law with regard to income in the case of corporations are believed to be equally applicable under the present law.

SALE OF CAPITAL STOCK. The proceeds from the original sale by a corporation of its shares of capital stock, whether such proceeds are in excess of or less than the par value of the stock issued, constitute the capital of the company. If the stock is sold at a premium, the premium is not income. Likewise, if the stock is sold at a discount, the amount of the discount is not a loss deductible from gross income. If, for the purpose of enabling a

porations, but generally the exemption of income applies equally to individuals and corporations. One of the classes of exempt income is gifts. Prior to the enactment of the 1916 Law it was not clear that a corporation was exempt from tax on the value of property acquired by gift. Under the 1909 Law gifts to corporations were held to be taxable as income, although the law was silent in this respect. Under the 1913 Law it was held that the statutory exemption of gifts did not apply to corporations, since the 1913 Law provided for such exemption under a provision applicable to individuals only and made no mention of such exemption in the provisions applicable to corporations. The 1916 Law provided for the exemption of the value of gifts in a section applying with equal force to corporations and individuals. (Compare Revenue Act of 1916, § 4, and Revenue Act of 1913, ¶ B.)

67 Revenue Act of 1921, § 236; Revenue Act of 1918, § 236.

68 Reg. 33 Rev., Arts. 91 and 92. See also Reg. 33, Arts. 104 and 105.

69 See Chaps. 14 et seq.

corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income of the corporation. A corporation realizes no gain or loss from the purchase of its own stock.[70]

Sale of Capital Assets. The sale by a corporation of its capital assets may produce a gain or loss in the same manner as the sale of property by an individual. The rules for determining this gain or loss are discussed elsewhere in this book. If the purchaser from a corporation takes over all the assets of a corporation and assumes all the liabilities, the amount of liabilities so assumed is part of the purchase price.[71]

Sale of Assets in View of Liquidation. Gains derived by a corporation from the sale of its assets with a view of liquidation are taxable income, whether or not the corporation is in process of liquidation.[72]

Creation of Sinking Fund. If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust, or sets aside certain amounts in a sinking fund under the control of a trustee, who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation. The trustee, however, is not taxable as such on account of the property or fund so held.[73]

Income from Leased Property. Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance or other fixed charges, such payments are to be considered rental pay-

[70] Reg. 45, Art. 542; Reg. 33 Rev., Arts. 98 and 99; T. D. 2090.

[71] Reg. 45, Arts. 545, 563 as amended by T. D. 3206, T. B. 33-21-1767. See Ch. 17. In the case of a bank the term "capital assets" includes bonds and other securities in which the bank has invested money received on deposit. (O. D. 832, T. B. 9-21-1485.)

[72] S. 1090, Treasury Bulletin 11-19-386. The distinction between the cases of Lynch v. Turrish, 247 U. S. 221, and Lynch v. Hornby, 247 U. S. 339, applies only for purposes of the tax liability of the shareholders as distinguished from the corporation.

[73] T. D. 3056, T. B. 35-20-1173.

ments and are to be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the stockholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or stockholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the stockholders such amounts are interest and dividend payments received as from the lessor and as such must be accounted for in their returns.[74]

CONTRIBUTIONS BY STOCKHOLDERS. Where a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its stockholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments in such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual stockholders, and will be treated as an addition to and as a part of the operating capital of the com-

[74] Reg. 45, Art. 546; Reg. 33 Rev., Arts. 102, 104, 125, 208; Reg. 33, Art. 82; T. D. 2090. The lessee, in making these payments direct to the bondholders and the stockholders, does so as the agent of the lessor. Where under the terms of a lease a lessee agreed to pay the interest upon and discharge the bonds issued by the lessor, to maintain the right of way and buildings, and to pay direct to each stockholder of the lessor dividends at the rate of eight per centum per annum, it was held that the amounts paid to the creditors and stockholders of the lessor were rents or compensation to the lessor for the use and occupation of its property and constituted net income to it. It was held to be immaterial that the lessor was not possessed of money or other cash revenues with which to pay the tax. The lessor could not exonerate itself from liability for the tax subsequently imposed under a law thereafter enacted by making a lease of its property which provided for the payment of all its surplus revenues direct to its stockholders. (Rensselaer & Saratoga Railroad Co. v. Irwin, 249 Fed. 726, writ of certiorari denied, 246 U. S. 671. See Northern Co. v. Lowe, 250 Fed. 856.) The notion that a corporation is an artificial entity distinct from the members who compose it is a fiction of the law which the courts recognize for some purposes and disregard for others. Thus, the fact that a lessee corporation pays the rent not to the lessor corporation, but to its stockholders and bondholders, cannot prevent the lessor corporation from being taxable. (Anderson v. Morris & Essex Railroad Co., 216 Fed. 83.)

pany.[75] If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation.[76]

Proceeds of Insurance. The 1918 law provided that "the proceeds of insurance policies paid upon the death of the insured *to individual beneficiaries or the estate of the insured* shall be exempt from tax".[77] The present law repeats this exemption, but omits the words in italics from the provision granting the exemption. The inference is clear that the intention of Congress was to exempt the proceeds of insurance policies paid upon the death of the insured irrespective of the status, corporate or otherwise, of the beneficiary. Under the 1918 law the proceeds of life insurance policies paid upon the death of the insured to a corporation beneficiary, less any premiums paid by the corporation and not deducted from gross income, were required to be included in gross income.[78] The option exercised by a corporation beneficiary in allowing the proceeds of an insurance policy to be paid in installments was held to represent an investment of such proceeds; any interest or profits received over and above the face value of each installment representing taxable income to the corporation for the year in which received.[79]

Where an individual took out a policy of insurance in favor of his estate which was assigned to a corporation as security for money advanced without interest or other charge to pay a premium thereon, and upon the death of the insured the corporation deducted the amount of the indebtedness from the proceeds of the policy paid to it as assignee, and turned the balance over to the executor of the estate, the corporation was not required to include the proceeds of the policy in gross income. The function of the corporation was merely that of an intermediary in the collection of the proceeds of the policy.[80]

Interest Upon Liberty Bonds. Income of a corporation as such is taxable to the corporation and not to the stockholders. The corporation, and not the stockholders, is regarded as the owner of Liberty Bonds held by the corporation and is entitled to exemption on account of such ownership. Thus, when bonds

[75] Reg. 45, Art. 543; letter from treasury department dated February 21, 1916; I. T. S., 1918, ¶ 1291.

[76] Reg. 45, Art. 51. See Oregon-Washington Co. v. U. S., 251 Fed. 211.

[77] Revenue Act of 1918, §§ 213 (b)1, 233; Revenue Act of 1921, §§ 213 (b) 1, 233.

[78] Reg. 45, Art. 541.

[79] O. D. 66, T. B. 1-19-92.

[80] O. D. 804, T. B. 7-21-1445.

of the Fourth Liberty Loan are subscribed for by the corporation, the corporation, as distinguished from its stockholders, is the original subscriber and is entitled to the collateral exemption of interest provided for years prior to 1921 on bonds of previous issues on account of such original subscription.[81]

Where a partnership was an original subscriber to liberty bonds of the Fourth Liberty Loan and was reorganized as a corporation prior to July 1, 1919, and elected to be taxed as a corporation from January 1, 1918, the corporation was considered, under the 1918 law, "the original subscriber" to the bonds.[82] When two corporations consolidate, forming a new corporation, the former corporations ceasing to exist, the new corporation could not be considered the original subscriber to bonds of the Fourth Liberty Loan originally subscribed for by the two corporations and taken over by it.[83]

Deductions in Computing Net Income. The statute specifies particularly the deductions which may be made by a corporation from its gross income in computing its net income. In general, the deductions from gross income allowed corporations are the same as allowed individuals, except that corporations may deduct dividends received from other corporations, which individuals use as a credit for purposes of the normal tax only, and may not deduct charitable contributions.[84] Certain items are also expressly declared by the Revenue Act of 1918 not to be deductible in the case of corporations as well as individuals. These items are discussed in another chapter.[85] These deductions are discussed generally in the several chapters relating respectively thereto.[86] In this chapter reference is made only to those provisions having special application to corporations.

ORDINARY AND NECESSARY EXPENSES. A corporation is allowed to deduct all the ordinary and necessary expenses paid or incurred[87] during the taxable year in carrying on any trade

[81] T. D. 2742. See Ch. 18 for a discussion of the consolidated exemption provided for 1921 and subsequent years.

[82] O. D. 502, T. B. 20-20-932; O. D. 211, T. B. 11-19-373.

[83] O. D. 577, T. B. 28-20-1052.

[84] Revenue Act of 1921, § 234 (a); Revenue Act of 1918, § 234 (a); Reg. 45, Art. 561.

[85] Revenue Act of 1921, §§ 215, 235; Revenue Act of 1918, §§ 215, 235; Reg. 45, Art. 581. See Ch. 21.

[86] See Chaps. 21-30.

[87] The terms "paid or incurred" or "paid or accrued" are construed according to the method of accounting upon which net income is computed under § 212 of the statute. (Revenue Act of 1921, § 200; Revenue Act of 1918, § 200.)

or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.[88] It will be noted that the expenses permitted by this provision of the law are only the *ordinary* and *necessary* expenses. Extraordinary expenses are not deductible under this head, although they may be deductions recognized in accounting practice as a proper charge against the income for the year. Payments to trustees by a cemetery company of a percentage of the proceeds of sales of cemetery lots set aside for a "maintenance fund" to be controlled solely by the trustees thereof pursuant to a provision in the charter of a corporation requiring such payments, are not deductible from the gross income as "ordinary and necessary expenses."[89]

ORGANIZATION EXPENSES. Organization expenses of corporations, such as attorneys' and accountants' fees, together with fees paid to state authorities prior to or coincident with the securing of a charter and the incorporation of a company, constitute a capital investment, such assets being offset by the asset value of the corporate franchise, an intangible asset of a somewhat permanent character and in many instances of substantial value. It is held that such expenses constitute investments of capital and are not "ordinary and necessary expenses," which are the only expenses authorized by the law to be deducted.[90]

EXPENSES INCURRED IN SALE OF CAPITAL STOCK. Expenses incidental to or connected with the selling of the capital stock (common or preferred) of a corporation for the purpose of raising capital to be invested by it in property to be employed in the business of the corporation are not an allowable deduction from gross income, for the reason that such expenses are incurred in a capital transaction; that is, the raising of capital to be invested or employed in the business. Such expense, like the discount at which the shares of stock may be sold, has the

88 Revenue Act of 1921, § 234 (a) 1; Revenue Act of 1918, § 234 (a) 1. In the case of corporations the statutory provision for this deduction contained in the Revenue Act of 1921 is identical with the corresponding provision of the 1918 Law. The rulings under the 1918 Law should therefore be followed under the present law.

89 S. 1145, T. B. 20-19-515.

90 Reg. 45, Art. 582; T. D. 2490. This ruling is not in accordance with accounting practice, which recognizes the propriety of charging off organization expenses against income over a period of four or five years.

effect only of reducing the available capital of the corporation and cannot be used to reduce the income from operations; that is to say, any expense incident to the bringing of capital into the company, whether it be a new or a going concern, cannot be recouped out of or charged against the operating income. It is a capital loss or expense properly chargeable against the proceeds of the sale of the stock and reduces the capital rather than the earnings of the company.[91]

REDEMPTION OR RETIREMENT OF CAPITAL STOCK. The expenses exclusive of the purchase price, incurred by a company in purchasing its own stock for the purpose of retirement or holding as treasury stock, are not deductible from gross income as "ordinary and necessary expenses." These expenses are to be considered part of the purchase price of the stock retired.[92] A reserve fund created out of the earnings of a corporation for the purpose of redeeming its preferred stock is not an ordinary and necessary expense.[93] Where a corporation issued preferred stock at par, redeemable at 110, the difference appearing on the books of the corporation as a reduction of undivided profits, the transaction has been held to be a capital transaction with the result that the difference between the selling price of the stock and the price at which it was redeemed could not be deducted.[94]

HOLDING COMPANY FINANCING SUBSIDIARY. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.[95] Moneys advanced as loans to a subsidiary to cover an annual deficit have been held not to be deductible as "ordinary and necessary expenses."[96] Payments by a holding company under a guaranty of interest on the bonds of an insolvent subsidiary are a legal deduction from the gross income of the corporation making the payment, either as an operating expense or

91 Reg. 45, Art. 563; Reg. 33 Rev., Art. 145.

92 O. D. 852, T. B. 12-21-1522.

93 O. D. 288, T. B. 22-19-537.

94 Letter from treasury department dated April 11, 1917; I. T. S. 1921, ¶ 1012.

95 Reg. 45, Art. 582.

96 Walker v. Gulf & Interstate Co., 269 Fed. 885; T. D. 3133, T. B. 13-21-1533.

as interest, or as a bad debt, provided it is charged off the books of account of the guarantor.[97]

INTEREST. Corporations, like individuals, may deduct all interest paid within the taxable year on their indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the corporation) the interest upon which is wholly exempt from income tax.[98] Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income. Interest paid by a corporation on so-called debenture stock, a kind of stock common in England, but more or less unfamiliar in this country, has been held deductible from gross income in computing net income.[99] In the case of banks and loan or trust companies interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income.[100]

[97] S. 1298, T. B. 8-20-753. It does not seem that the amount of the deduction need be charged off unless deducted as a worthless debt.

[98] Revenue Act of 1921, § 234 (a) 2; Revenue Act of 1918, § 234 (a) 2. The 1921 Law contains an important change from the 1918 Law in the insertion of the words "and originally subscribed for by the taxpayer" in the parenthetical clause of subd. (2) of ¶ (a) of § 234. This change is designed to prevent the deduction of interest paid or accrued to purchase or carry Victory 3¾ notes and is fully explained in Ch. 23. The 1916 Law contained a substantial limitation upon the deduction of interest by corporations. With regard to this limitation see: Revenue Act of 1916, § 12; T. D. 2441; T. D. 2137; T. D. 2090; T. D. 1865; T. D. 1993; T. D. 1960; Reg. 33 Rev., Arts. 95, 188; Reg. 33, Art. 95, Art. 148, Art. 151. Letter from treasury department dated April 29, 1918; I. T. S. 1918, ¶ 3344; letter from treasury department dated January 13, 1916; I. T. S. 1918, ¶ 1767. Anderson v. 42 Broadway Co., 239 U. S. 69; Associated Pipe Line Co. v. U. S., 258 Fed. 800; Altheimer Investment Co. v. Allen, 246 Fed. 270, petition for a writ of certiorari denied November 18, 1918; Middlesex Banking Co. v. Eaton, 233 Fed. 87. The limitation is discussed in full in the 1920 edition of this book at p. 855. Since that discussion was written the following decisions have been made bearing upon the subject-matter: Boston & M. R. R. v. U. S., 265 Fed. 578; U. S. v. N. Y., N. H. & H. R. R. Co., 265 Fed. 331; Sol. Op. 23, T. B. 39-20-1217; A. R. R. 559, T. B. 29-21-1733; Sol. Op. 127, T. B. 47-21-1934.

[99] A. R. R. 237, T. B. 33-20-1142. The character of the debenture stock involved in this ruling is thoroughly described in the chapter herein on the excess-profits tax under the heading of borrowed capital.

[100] Reg. 45, Art. 564.

TAXES. Corporations, like individuals, may deduct taxes paid or accrued,[101] within the taxable year, except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) that part of any income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit, and (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed.[102] Under a new provision of the Revenue Act of 1921, taxes imposed upon a shareholder or member of a corporation, upon his interest as shareholder or member, which are paid by the corporation without reimbursement, are deductible by the corporation.[103] This provision applies particularly to banks. The shareholder or member is, of course, not permitted to deduct the same tax. Additional taxes assessed against a corporation under the 1909 law and paid during subsequent years are allowable deductions from the gross income of the corporation for the year when paid, but income taxes assessed under the 1913 law and the 1916 law are deductible only if paid prior to January 1, 1917.[104] Except as stated in this and following paragraphs the same rules apply to the deduction of taxes by corporations and individuals and are discussed elsewhere.[105]

INTEREST ON TAX-FREE BONDS. Where a corporation has issued bonds or other indebtedness with a guarantee that the interest thereon shall be paid without deduction for any tax which the corporation may be called upon to pay or withhold under the laws of the United States or of any state or jurisdiction, no deduction for the payment of the income tax or any other federal tax paid pursuant to the contract or provision contained in such bonds is permitted to the corporation under the heading of taxes or interest or on any ground. In the case, however, of corporate bonds or obligations containing an appropriate "tax-free covenant" clause, the corporation paying a state

[101] See note 87.

[102] Revenue Act of 1921, § 234 (a) 3. The taxes which are allowed as a credit are set forth in § 238. In this provision for the deduction of taxes the 1918 Law described particularly the taxes which were deductible as well as some exceptions; the present law describes particularly only the exceptions —that is, the taxes not deductible. The two sections should be carefully compared; they are discussed in full in ch. 24.

[103] Revenue Act of 1921, § 234 (a) 3. Formerly such taxes were not deductible by the shareholder, but only by the member. This subject is fully discussed in ch. 24.

[104] O. D. 240, T. B. 13-19-418. See ch. 24.

[105] Reg. 45, Art. 565. See ch. 24.

tax or any other than a federal tax for some one else pursuant to its agreement may deduct such payment as interest paid on indebtedness.[106] Under the 1918 law the amount of tax so paid for a bondholder by an obligor pursuant to a tax-free covenant was regarded as additional interest paid to the bondholder and was required to be included in gross income.[107] The Revenue Act of 1921 expressly provides that the tax so paid shall not be included in the gross income of the obligee (bondholder).[108]

LOSSES. Corporations are permitted to deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise, unless, in order to clearly reflect the income, the loss should, in the opinion of the commissioner, be accounted for as of a different period.[109]

LOSSES IN ULTRA VIRES TRANSACTIONS. Where a corporation suffers a loss as the result of an *ultra vires* act, it may not deduct such loss in computing its net income. Where a corporation is authorized by its certificate of incorporation to purchase stocks on a margin, and where there are no laws in the state where it trades in stocks making marginal stock transactions by corporations illegal, if it sustains a loss as a result of marginal trading in stocks, such loss may be deducted in computing its net income, if sustained during the taxable year and not compensated for by insurance or otherwise, unless it appears affirmatively that the transaction was merely colorable and no *bona fide* purchase of stock was made.[110]

DIVIDENDS ON STOCK OF OTHER CORPORATIONS. The dividends which may be deducted by corporations in computing net income are the same as those which individuals may use as a credit for purposes of the normal tax. Under the Revenue Act of 1921 corporations may deduct amounts received as dividends (a) from a domestic corporation (other than a corporation deriving a substantial proportion of income from sources within a possession of the United States and entitled to be treated as a foreign corporation) or (b) from any foreign corporation

[106] Revenue Act of 1921, § 234 (a) 3; Revenue Act of 1918, § 234 (a) 3; Reg. 45, Art. 565.

[107] Reg. 45, Art. 31.

[108] Revenue Act of 1921, § 234 (a) 3.

[109] Revenue Act of 1921, § 234 (a) 4; Revenue Act of 1918, § 234 (a) 4. The provision for "net losses" and the new "wash sale" provision of the Revenue Act of 1921 apply similarly to individuals and corporations and are discussed in ch. 25. The provision of the 1918 Law for the deduction of losses in inventory and from rebates is also discussed in that chapter.

[110] O. 968, T. B. 1-20-660.

when it is shown to the satisfaction of the commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States.[111] Under the 1918 law corporations might deduct all amounts received as dividends from a corporation taxable upon its net income and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax had been imposed.[112] Dividends paid by foreign corporations receiving no income from sources within the United States might not be deducted. An American corporation might deduct all amounts received as dividends from a foreign holding company whose income was derived entirely from dividends on the stock of another American company.[113]

CONTRIBUTIONS TO CHARITIES. Under both the present and the 1918 law corporations are not entitled to deduct from their gross income contributions made to the United States, any state, territory, or the District of Columbia, for public purposes, or to religious, charitable, scientific or educational corporations or organizations, including the American Legion, or to the fund for vocational rehabilitation. Contributions made to the Red Cross or other war activities are not deductible by corporations.[114]

111 Revenue Act of 1921, § 234 (a) 6. See also §§ 216, 217, 262.

112 Revenue Act of 1918, § 234 (a) 6. Under the 1913 Law corporations were not permitted to deduct the amount received as dividends from other corporations subject to the income tax. This was likewise true under the 1916 Law. For the purpose of the 1917 Law, dividends on the stock of such other corporations as were taxable thereunder on their net income might be deducted. Thus, in 1917 a corporation might not deduct dividends in computing the 2% tax imposed by the 1916 Law, but might do so in computing the 4% tax imposed by the 1917 Law.

113 O. D. 130, T. B. 3-19-201.

114 T. D. 2847, as amended May 24, 1919. This treasury decision was founded on an opinion of the attorney-general dated May 19, 1919, which held that Red Cross donations were not deductible as expense, and which was also founded on a consideration of the legislative history of the Revenue Act of 1918. (See Congressional Record for September 17, 1918, in which it appears that an amendment to the effect that corporations might deduct charitable and other contributions and gifts in the same manner as individuals was defeated.) It was not necessary to file amended returns when donations had been erroneously deducted prior to the promulgation of T. D. 2847. It was simply necessary to file a statement showing the amount of donations, the net income as reported and corrected, and the additional tax which was required to be paid, together with interest from each installment

Sale and Retirement of Corporate Bonds. The rules for the computation and allocation of income and deductions upon a sale and retirement of corporate bonds stated below as issued under the 1918 law should remain substantially unchanged under the present law. If bonds are issued by a corporation *at their face value,* the corporation realizes no gain or loss. If thereafter the corporation purchases and retires any of such bonds at a price *in excess* of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. If, however, the corporation purchases and retires any of such bonds at a price *less* than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

If bonds are issued by a corporation *at a premium,* the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. If thereafter the corporation purchases and retires any of such bonds at a price *in excess* of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. If, however, the corporation purchases and retires any of such bonds at a price *less* than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year.

If bonds are issued by a corporation at *a discount,* the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If thereafter the corporation purchases and retires any of such bonds at a price *in excess* of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the cor-

date. Failure to file such a statement resulted in the 5% penalty upon audit of the return. (T. D. 3105, T. B. 1-21-1385; M. 2207, T. B. 14-19-438.) Payment of the additional tax was required within 30 days. The statement was not required when the amount of donations was disclosed upon an audit of corporate books by the department (T. D. 3215).

poration purchases and retires any of such bonds at a price *less* than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year.[115]

It was claimed in one case that the excess of the par or face value of a corporation's bonds, issued prior to March 1, 1913, over the price paid upon the purchase and retirement of the bonds was not income, the bonds having depreciated prior to that date, by reason of the impaired capital of the corporation, to a value equivalent to that paid for the bonds in 1918. This claim was, in other words, that the corporation received the excess in question when the bonds were sold prior to March 1, 1913, so that such excess was not taxable income; and that the corporation received no income in 1918, merely because in that year it transpired that the excess received prior to March 1, 1913, need not be paid back. This claim was not allowed, however, the committee deciding that the excess in question was properly taxable in 1918.[116]

A corporation which issued its bonds at a discount and improperly charged the discount to profit and loss may correct its books to show the discount treated as interest paid in advance, to be amortized over the life of the bonds. Amended returns reflecting a correction in the books may be filed. If, however, the bonds were issued prior to the incidence of the tax and, at that time, the entire amount of the discount was charged to profit and loss, the issuing corporation may not claim a *pro rata* allowance for such discount for the years subsequent to the incidence of the tax.[117] Charging off the discount prior to the incidence of the tax constitutes a closed transaction and such transaction cannot be reopened for the purpose of reducing the taxable income of the corporation.[118] Thus where a railroad company sold bonds and equipment notes at a discount in 1906 and its books show that the loss was entirely charged off under

[115] Reg. 45, Art. 544; Baldwin Locomotive Works v. McCoach, 221 Fed. 59. This discount was formerly treated as a loss prorated over the life of the bonds (Reg. 33 Rev., Art. 150). The 1909 Law which authorized the deduction only of "interest actually paid within the year on its bonded or other indebtedness" did not permit the deduction each year of a reserve set aside to pay a discount at maturity (Southern Pacific R. R. Co. v. Muenter, 260 Fed. 837).

[116] A. R. R. 545, T. B. 27-21-1717.

[117] O. D. 111, T. B. 2-19-166.

[118] T. D. 2161, T. D. 2137.

the profit and loss account for 1906, and the company in making returns for the years 1911 and 1912 failed to deduct the proportionate amount of discount sustained, it has no right to amend its returns and claim a refund of such amount.[119]

Where bonds mature serially, a proper proportion of the total discount and expenses should be allocated to each series and each series then treated as a separate unit. The deduction applicable to each series should be prorated equally over the life of the bonds constituting the series, provided, however, that if the corporation retires any of the bonds before maturity, the deduction for that year should be increased by an amount equivalent to the amount which would ordinarily be deducted during the succeeding years on account of those particular bonds if they had not been prematurely retired.[120]

Where a sole proprietor of an unincorporated business issued mortgage bonds, some of which were traded for Liberty bonds, which had a market value of less than par, but were taken at their par value, there being trustee's expenses and agent's commissions incident to the selling of the bonds, it has been held that when he exchanged the mortgage bonds for Liberty bonds, he, in effect, disposed of the bonds at a discount, the amount of which is represented by the difference between the par value of his bonds and the fair market value of the Liberty bonds when taken in exchange therefor. Such discount is deductible and should be prorated or amortized over the life of the bonds. The trustee's expenses and agent's commissions incident to the floating of the bonds constitute a deductible expense which should be prorated over the life of the bonds.[121]

Amortization of premiums or discount on bonds is not permissible in the case of a purchaser of bonds. The purchase price of the bond, even though different from par, represents the investment.[122]

Credits Against Net Income. In addition to the deductions which corporations are permitted in computing their net income, corporations are allowed certain credits against net income. Credits differ from deductions in the case of corporations in that deductions reduce the net income for the purpose of all taxes, while credits reduce the net income for the purpose of the in-

119 Chicago & Alton R. R. Co. v. U. S., 53 Ct. Cls. 41.
120 O. D. 936, T. B. 22-21-1665.
121 O. D. 959, T. B. 26-21-1704.
122 O. D. 475, T. B. 17-20-887.

come tax and not for the purpose of the excess-profits tax.[123] The credits are discussed in the following paragraphs.

INTEREST UPON OBLIGATIONS OF THE UNITED STATES. The amount of interest received by a corporation upon obligations of the United States issued prior to September 1, 1917, is exempt from all taxation, and is excluded from the gross income of the corporation. The amount of interest upon obligations of the United States issued after September 1, 1917, (other than postal savings certificates of deposit) and upon bonds issued by the War Finance Corporation is exempt from taxation only if and to the extent provided in the respective acts authorizing the issue thereof, as amended and supplemented, and is excluded from gross income only if and to the extent it is wholly exempt from income, war-profits and excess-profits taxes. Corporations are allowed a credit against net income for the purpose of the income tax of any amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income.[124]

AMOUNT OF WAR-PROFITS AND EXCESS-PROFITS TAX. Corporations are also allowed a credit for purposes of the income tax, of the amount of the war-profits and excess-profits tax imposed for the same taxable year.[125] In the case of a corporation making return for a fiscal year beginning in 1920 and ending in 1921, or beginning in 1921 and ending in 1922, certain special rules apply, which are set forth elsewhere in this book.[126] An addition to excess-profits tax, on a delinquent or false and fraudulent return, is to be considered a penalty and not a tax, except for purposes of collection, and is not an allowable credit.[127]

SPECIFIC EXEMPTION. Under the 1918 law domestic corporations were permitted a credit for purposes of the income tax of the sum of $2,000 as a specific exemption.[128] Where for

[123] After December 31, 1921, when the excess-profits tax is abolished, these credits (except the war-profits and excess-profits tax) would seem to be the equivalent of deductions. This means that the specific exemption will amount to a deduction, but with respect to interest upon obligations of the United States it seems that the useless formality of including gross income an exact amount later deducted from gross income must be observed.

[124] Revenue Act of 1921, §§ 236 (a), 233, 213 (a) 4; Revenue Act of 1918, §§ 236 (a), 233, 213 (a) 4; Reg. 45, Art. 591.

[125] Revenue Act of 1921, § 236 (c); Revenue Act of 1918, § 236 (b); Reg. 45, Art. 591.

[126] See ch. 24.

[127] O. 926, T. B. 23-19-551.

[128] Revenue Act of 1918, § 236 (c); Reg. 45, Art. 591 The 1916 Law and the 1913 Law contained no similar provision.

any cause, a corporation filed a return for a period of less than 12 months, the specific exemption was such proportion of $2,000 as the number of months in the period bore to 12 months. If the period for which the first or final return was made included a fraction of a month there was added to the number of complete months as many thirtieths of a month as there were days in the fractional part of the month.[129] In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000 is allowed under the present law; but if the net income is more than $25,000 the income tax must not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.[130]

Credits Against Tax. Domestic corporations may credit against the amount of tax which would be due on income derived from all sources the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States. This credit, and the limitation applicable thereto is discussed in another chapter.[131]

Receivers for Corporations. The Revenue Act of 1921 provides that in cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. This is true notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court. Any tax due on the basis of such returns made by receivers, trustees or assignees is collected in the same manner as if collected from the corporations of whose business or property they have custody or control.[132] Receivers of corporations are not fiduciaries within the meaning of the law and are not governed by the rules applicable to receivers for individuals.[133] The receiver of a corporation stands in the same posi-

[129] O. D. 756, T. B. 51-20-1356.

[130] Revenue Act of 1921, § 236 (b). The effect of this limitation is to prevent an increase of $1 in net income resulting in an increase of $250 in tax.

[131] Revenue Act of 1921, § 238; Revenue Act of 1918, § 238. See ch. 32.

[132] Revenue Act of 1921, § 239; Revenue Act of 1918, § 239.

[133] Reg. 45, Art. 424; O. D. 821, T. B. 8-21-1468. This is true in view of the express provision of § 239, notwithstanding the definition of "person" and "fiduciary" contained in § 200. See ch. 6.

tion as the officers of a solvent corporation and upon him devolve all the duties of such officers as to the making of returns and payment of tax. The fact that the business and property of the corporation are temporarily in the hands of a receiver does not alter the fact that the corporation is the beneficiary of the income arising and accruing. If there is net income in excess of credits, it is taxable, and the custodian of such income is liable for the tax assessable thereon.[134] Where the property of a corporation is placed in the hands of trustees to dissolve the corporation, such trustees should make returns in the same manner and form as corporations are required to make returns, at least, unless they are merely engaged in marshalling, selling and distributing the assets of the corporation.[135] But where trustees have taken the property of a Minnesota corporation at the expiration of its charter and continue the business until the property can be disposed of advantageously, it is held that they are not trustees in dissolution, but are acting for themselves as trustees of a trust property. The full power and control over the property being in the trustees, they are trustees under a mere trust, and do not constitute an "association."[136]

A receiver whose duties extend through the end of the year should prepare and file a corporate return for the entire taxable year, including therein the gross income received by the corporation prior to the time of his appointment, and also the gross

134 Under the 1913 Law, as well as under the 1909 Law, there was no express provision in the statute taxing corporations in the hands of receivers. Several cases under the 1909 Law held that that act did not impose a tax on such corporations or any duties on the receivers thereof. (See Pennsylvania Steel Co. v. New York City Railways Co., 193 Fed. 286; 198 Fed. 774, affirmed U. S. v. Whitridge, 231 U. S. 144; O. 1009, T. B. 11-20-787. The 1909 Law was a tax on corporations doing business and it was held in several cases that a corporation in the hands of receivers was not one doing business within the meaning of those words as used in that act. Only one decision seems to have been rendered under the 1913 Law, and in that case it was held that receivers were not subject to the income tax where the court took possession of the property of an insolvent railroad company and operated the railroad. The funds in the hands of the receivers, represented by the net proceeds in conducting the operation of the road, over and above the authorized expenditure paid out by them, were held not to be subject to the tax as "net earnings." (Equitable Trust Co. v. Western Pac. Ry. Co., 236 Fed. 814, affirmed Scott v. Western Pac. Ry. Co., 246 Fed. 545.) The question was no longer left open under the express provisions of the 1916 Law.

135 O. D. 884, T. B. 16-21-1584. The trustees of an Ohio corporation would be required to make a return in behalf of the corporation. They wholly supersede the officers of the corporation.

136 O. D. 931, T. B. 22-21-1658. See paragraph, "Trusts not taxable as associations," above.

income received under his supervision.[137] It is not clear whether a receiver is obliged to render a return for the period extending from the end of a taxable year to the date when he concludes his duties or is discharged, or whether such a return must be made by the corporation. It would seem that the receiver is responsible for a return covering that part of the year during which he acted as receiver, but it has been held that a return may be made by the corporation to whom the receiver returns the corporate property for the full period including the part of the year when the receiver was in control and the part after the property is returned to the corporation.[138]

A receiver in charge of only part of the property of a corporation, however, as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.[139]

The receiver liquidating the assets of an insolvent bank is required to file a return for the bank, but in view of the fact that the bank is insolvent he will have no tax to pay. The return may contain a statement to that effect in lieu of the data ordinarily required.[140]

INCOME TAXABLE IN HANDS OF TRUSTEE IN BANKRUPTCY. It has been held under the 1916 law that the only income taxable in the hands of a trustee in bankruptcy is the income earned by the trustee while operating the business of a bankrupt corporation. Thus, funds representing the result of a compromise made by the trustee with a foreign corporation of a claim for the nonpayment of salaries and commissions by the foreign corporation to the bankrupt corporation as its agents between the years 1910 and 1914 have been held to be exempt from tax in the hands of the trustee in bankruptcy.[141]

INCOME TAXABLE IN HANDS OF ASSIGNEE. Income received by assignees appointed by a corporation to liquidate its prop-

[137] O. D. 73, T. B. 1-19-102; O. D. 884, T. B. 16-21-1584.

[138] See O. D. 557, T. B. 25-20-1018; O. D. 873, T. B. 15-21-1565; O. D. 884, T. B. 16-21-1584.

[139] Reg. 45, Art. 622.

[140] O. D. 114, T. B. 2-19-170. Such insolvent bank would have no tax to pay because of § 22 of the Act of March 1, 1879, which provides that no tax shall be assessed or collected or paid into the United States treasury on account of a bank which has ceased to do business by reason of insolvency or bankruptcy which shall diminish the assets thereof necessary for the full payment of all depositors. No action will be taken against the receiver until depositors' claims have been fully satisfied (O. D. 990, T. B. 32-21-1763).

[141] In re Heller Hirsh & Co., 258 Fed. 208.

erty and business over a period of years, who have full power of control and management thereof, is taxable. This is true although the business conducted by the trustees in the process of liquidation is not the business which the corporation originally started to conduct. This rule applies to all income received by the trustees, including interest on bank deposits, interest upon deferred payments, and gains upon sales of real property.[142]

Fiscal Year. A corporation is required to make returns and pay the tax on the basis of its annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping its books, unless (a) no such method of accounting has been employed, or (b) the method employed does not clearly reflect income. In case of (a) and (b) the computation of net income is made on such basis and in such manner as in the opinion of the commissioner does clearly reflect income. If the corporation's annual accounting period is other than a fiscal year, or if the corporation has no annual accounting period, or does not keep books, its net income is computed on the basis of the calendar year. In the event of any change of accounting period from fiscal year to calendar year, or vice versa, or from one fiscal year to another, net income is computed on the basis of such new accounting period, subject to the rules outlined in a later chapter.[143] Reporting upon the basis of a fiscal year was formerly a privilege accorded to corporations and partnerships only. It is now a requirement if the annual accounting period of the corporation is a fiscal year. This subject is more fully treated in another chapter.[144]

Returns. The duty to make a return depends upon corporate existence and not upon the receipt of income. Every corporation not expressly exempt is required to make a return regardless of the amount of its net income.[145] Even a potential corporate existence which may be called into action by the proper authority without affecting the identity of the corporate body will be sufficient to necessitate the filing of a return. Thus, where a stockholder purchased the name, merchandise and business of a Michigan corporation and as sole stockholder operated the

[142] O. D. 853, T. B. 6-19-280; O. D. 931, T. B. 22-21-1658. See footnote 136.

[143] Revenue Act of 1921, §§ 212, 232; Revenue Act of 1918, §§ 212, 232; Reg. 45, Art. 25.

[144] See ch. 34.

[145] Reg. 45, Art. 621; O. D. 882, T. B. 16-21-1582; O. D. 919, T. B. 20-21-1641.

enterprise as an individual instead of as a corporation under a "change of attitude" filed with the secretary of state, a corporate return was required, because the corporation was not dissolved, its powers being only suspended.[146] Copies of the prescribed return forms will be furnished corporations by collectors. Failure on the part of any corporation liable to tax to receive a prescribed blank form will not, however, excuse it from making the return. Corporations not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified and filed with the collector on or before the due date. Each corporation should carefully prepare its return so as fully and clearly to set forth the data therein called for. Imperfect or incorrect returns will not be accepted as meeting the requirements of the statute. In lack of a prescribed form a statement made by a corporation disclosing its gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the corporation from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form, or an extension of time is obtained.[147]

WHEN FILED. Returns of income must be made by domestic corporations (except those which are treated as foreign corporations) on or before March 15th or the 15th day of the third month following the close of the fiscal year for which the return is required to be made.[148]

EXTENSION OF TIME. A corporation desiring an extension of time within which to file its return should submit to the collector before the time for filing the return a tentative return and estimate, accompanied by a remittance of not less than one-fourth of the estimated amount of income and excess-profits taxes for the taxable year. In such a case the collector may grant a reasonable extension of time for filing the complete

[146] O. D. 919, T. B. 20-21-1641; O. D. 1120, T. B. 48-21-1951. See paragraph, "De Facto Corporations," above.

[147] Reg. 45, Arts. 621 and 407; Reg. 33 Rev., Art. 203; Reg. 33, Art. 80. Under the 1909 Law it was held that corporations of all kinds specified in the act as subject to the tax were bound to file returns though their net profits were not sufficient to *render them liable to the tax* (U. S. v. Military Construction Co., 204 Fed. 153), and that the duty to make returns was not limited to those the net profits of which were sufficient to *render them liable to the payment of the tax.* (U. S. v. Acorn Roofing Co., 204 Fed. 157.)

[148] Revenue Act of 1921, §§ 227 (a), 241 (a); Revenue Act of 1918, §§ 227 (a), 241 (a).

return, not to exceed 30 days from the date on which the return was originally due.[149]

WHERE FILED. Corporate returns are filed with the collector of the district in which is located the principal place of business or principal office or agency of the corporation. If a domestic corporation keeps its books of account and other data in a foreign country and has no principal place of business or principal office in this country, the return should be made to the collector in the district in which the corporation has its principal agency in this country.[150] If it has no such agency or branch office in this country, the return should be made to the collector of the district in which is located its statutory office; that is, the office required to be maintained in the state of incorporation in accordance with the statutes of that state.[151] It is to be noted that a corporate return is not ordinarily to be filed in the district in which is located the statutory office, unless the corporation has no principal place of business or principal office or agency from which the return can be filed. The purpose of designating the principal business office is for the convenience of the treasury department in examining the books of the corporation and verifying the return. Since the statute now expressly designates the principal place of business or principal office or agency, the filing of a return from another office may not be considered a proper filing.[152]

BY WHOM FILED. Responsibility for filing corporate returns rests upon the principal officers of the corporation, although there is no penalty on such officers personally for failure to file returns. The only personal penalty on officers is for wilfully refusing to make the return, pay the tax, supply information required, or in any manner attempting to defeat or evade the tax.[153]

HOW SIGNED AND SWORN TO. The return is required to be sworn to by the president, vice president or other principal officer of the corporation and by the treasurer or assistant treasurer,

149 See ch. 34.

150 Revenue Act of 1921, § 241 (b); Revenue Act of 1918, § 241 (b).

151 T. D. 2137.

152 The 1916 Law required corporate returns to be made "to the collector of the district in which is located the principal office of the corporation, company or association, where are kept its books of account and other data from which the return is prepared." The 1913 Law was less explicit and might have been held to justify the filing of corporate returns from some other office, but the present law and the 1918 Law, as well as the 1916 Law, are open to no such construction.

153 Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.

and must be verified under the oath of such officers, except in the cases where the return is filed by a receiver, trustee, or assignee, or directors in the case of insolvency, in which cases the affidavit on the return should be changed in accordance with the facts.[154] When the treasurer or assistant treasurer of a corporation is the only officer available to swear to the corporation return, it is held to be *pro tanto* a sufficient compliance with the statute if he signs and swears to the return as such treasurer or assistant treasurer and signs also for the president, vice president or other principal officer.[155]

Corporations Formed During the Year. A corporation organized during the year is required to make a return covering that portion of the year during which it was in existence.[156] But the return must cover only the period during which the corporation was legally in existence.[157] Where a corporation was organized to take over a partnership business in June and the transaction is consummated as of the past January 1st, the taxable period of the corporation will begin as of June.[158] The fact that a new corporation organized in the year has transacted no business does not excuse it from making a return.[159] Corporations which have applied for, but not received, charters, or corporations which have received charters, but have not perfected their organizations, transacted any business and had any income whatever from any source, may, upon the presentation of these facts to the local collector be relieved from the necessity of making returns so long as they remain in this unorganized condition. In the absence of a proper showing to the collector, such a corporation will be required to make a return.[160] When a distinct new corporation is organized to take over the property of an old corporation, both corporations will be required to make returns covering the periods of the year during which they were each respectively in charge of the business, or file a consolidated return.[161] Where a contract provided that on December 31, 1919, a new corporation should take over the assets and liabilities of an old corporation as of October 4, 1919, it was held that the old corporation must make return for

154 Revenue Act of 1921, § 239; Revenue Act of 1918, § 239. See ch. 34.

155 O. D. 911, T. B. 19-21-1628.

156 Reg. 45, Art. 621; Reg. 33, Art. 84.

157 O. D. 1016, T. B. 35-21-1796.

158 O. D. 1121, T. B. 48-21-1952.

159 Reg. 45, Art. 621; O. D. 574, T. B. 27-20-1044; T. D. 2090.

160 Reg. 45, Art. 621; T. D. 2152; O. D. 1120; T. B. 48-21-1951.

161 Reg. 33 Rev., Art. 206; T. D. 2137. But if there is a mere change in domicile this will not be true (O. D. 1119, T. B. 48-21-1950).

the full year 1919, including the profit, if any, made from the sale of its property to the new corporation.[162]

Change of Name or Domicile. A mere change in name does not constitute a new corporation. If the business was continuous throughout the year, no change in management or operation other than the change in name having occurred, the return should be made covering the business transacted throughout the year, such return to be made by the corporation in the name which it bears at the end of the year, with a notation on the return to the effect that the name had been changed, giving both the old and the new names.[163] Since in the conversion of a state bank into a national bank there is not a dissolution of the corporation, but merely a change of title and the extension of government supervision thereover, a bank so changing during the taxable year must file one return for the entire year.[164] Where there is a mere change of domicile during the year without change of business or in capital and surplus, only one return is necessary for the operations of both corporations.[165]

Corporations Liquidating During the Year. A corporation entirely out of business, maintaining its corporate existence merely for the purposes of liquidation, and still holding income-producing investments not yet due, is required to file returns for each year embracing the liquidating period.[166] A corporation going into liquidation during any taxable year may upon the completion of such liquidation prepare a "final return" covering its income during the fractional part of the year during which it was engaged in business and may immediately file such return with the local collector.[167] Where a corporation is

162 O. D. 1025, T. B. 36-21-1808.

163 Reg. 33 Rev., Art. 206; T. D. 2137.

164 O. D. 476, T. B. 17-20-888; see also A. R. R. 285, T. B. 42-20-1252.

165 O. D. 1119, T. B. 48-21-1950.

166 O. D. 231, T. B. 12-19-406.

167 Reg. 45, Art. 651; Reg. 33 Rev., Art. 205; Reg. 33, Art. 85; T. D. 2209; T. D. 2090. This return should be filed by the directors or other persons in charge of the winding up of the corporation. Under the Corporation Act of New Jersey (P. L. 1896, p. 295), which provides that corporations, however dissolved, are "continued bodies corporate for the purpose of prosecuting and defending suits by or against them and of enabling them to settle and close their affairs," and constitutes the directors trustees to settle the business, the officers of a corporation which had been dissolved after becoming subject to the tax on its income of the preceding year, who were also its directors, were held to have authority and to be under the duty of making the return of such business required by the 1909 Law. (U. S. v. General Inspection and Loading Co., 192 Fed. 223; 204 Fed. 657.)

completely dissolved before the close of its taxable year, it has the same time in which to file its final return as if it had continued its existence during its entire taxable year, and in case it files its final return before the time provided by law it can not be compelled at the time of filing such return to pay any tax shown to be due thereon. The first installment of tax is due on the date the return would have been due if it had covered the full taxable year.[168] The treasury department will waive the filing of evidence of the completion of liquidation required by the Illinois statutes and will accept a final return from a corporation, if accompanied by a certificate of the court showing that all requirements of the law with regard to dissolution of the corporation and distribution of its assets have been satisfied, except as to evidence of payment of federal income taxes, and that actual winding up of the corporation merely awaits formal court action. Upon payment of all federal income tax shown to be due from the corporation, the collector will issue the necessary receipt.[169] It seems to be within the power of the commissioner to declare the taxable period of a corporation terminated at the time it is dissolved and to demand immediate payment of the tax for such taxable period and the tax for the preceding year or to require security for the payment thereof.[170] This remedy is more fully discussed elsewhere in this book.[171] Where a corporation, by affidavit or otherwise, has clearly established the fact and satisfied the collector that it is defunct, dissolved or obsolete and is no longer carrying on business and has no property or income, returns will not be required after such condition has been clearly established. Only one showing of this character is required, unless it appears later that the corporation has income.[172]

Corporations in Hands of Alien Property Custodian. The proper officers of a corporation that has been taken over by the Alien Property Custodian should file a return for the corporation up to the time the property was taken over by the Alien Property Custodian. The board of directors appointed by the Alien Property Custodian is not required to render a return for the corporation while in control of the Alien Property Custodian.[173]

168 O. D. 692, T. B. 42-20-1253.

169 O. D. 672, T. B. 39-20-1214.

170 Revenue Act of 1921, § 250 (g); Revenue Act of 1918, § 250 (g); O. D. 692, T. B. 4-20-1253.

171 See Chapter 35.

172 T. D. 2137.

173 O. D. 148, T. B. 4-19-231.

Returns for Fractional Part of Year. In the case of a corporation making its first return of income on the basis of a fiscal year and in the case of a corporation changing its accounting period, whether from calendar year to fiscal year, from fiscal year to calendar year, or from one fiscal year to another fiscal year, a separate return for a fractional part of a year is required. Such a return for a period of less than twelve months should be made according to the rules discussed in another chapter.[174]

Amended Returns Where Capital Charges Have Been Made to Income. A corporation may submit amended returns for previous years, when through wrong accounting practice, capital charges have been made to income. An affidavit should be attached, explaining the changes made by such amended returns and explaining why the original returns were not properly prepared and the object of the company in preparing amended returns. Such amended returns will be accepted only when the erroneous charge can be specifically pointed out and the facts proved. The treasury department reserves the right to penalize for the making of false returns in the past.[175]

Distribution of Earnings. There must be included in every corporate return, or appended thereto, a statement of such facts as will enable the commissioner to determine the portion of the earnings or profits of the corporation (including gains, profits and income not taxed) accumulated during the taxable year for which the return is made, which have been distributed or ordered to be distributed, respectively, to its stockholders or members during such year.[176]

Consolidated Returns. The Revenue Act of 1921 gives affiliated corporations, for any taxable year beginning on or after January 1, 1922, the option of making separate or consolidated returns. If return is made on either of these bases, returns made thereafter must be upon the same basis unless permission to change is granted by the commissioner.[177] The purpose of and reason for this change may best be gathered from the report of the chairman of the senate finance committee, in which the following is stated:[178] "Under existing law affiliated corporations are required to make consolidated returns. Owing to the complexity of the consolidated return in certain instances, the

[174] See Chapter 34; see Reg. 45, Art. 626; O. D. 352, T. B. 31-19-650.

[175] O. D. 113, T. B. 4-19-231.

[176] Revenue Act of 1921, § 239 (e). This is a new provision.

[177] Revenue Act of 1921, § 240a.

[178] See Report of Senate Finance Committee on Internal Revenue Bill of 1921, p. 20.

corporations affected would prefer not to make such consolidated return, although it benefits affiliated corporations when one or more of them sustain a loss. The consolidated return is necessary to prevent evasion under the excess-profits tax, but this necessity will disappear when the excess-profits tax is repealed." The Revenue Act of 1921 makes no change in its definition of affiliated corporations, except that the accounts of closely related trades or business may be consolidated, as is more fully indicated below.[179] Like the 1918 law, the Revenue Act of 1921 provides that "in any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each," and that there shall be allowed in computing the income tax only one specific credit.[180] Since corporations which are affiliated may file consolidated returns after January, 1922, and must file such returns for the years 1917, 1918, 1919, 1920 and 1921, it is important to consider the rulings and decisions bearing upon the filing of consolidated returns under the 1918 and 1917 law.[181] The rulings discussed below were made under the 1918 law, except as otherwise indicated.

CONSOLIDATED RETURNS UNDER 1918 LAW. Under the 1918 law affiliated corporations were required to file consolidated returns on Form 1120. The consolidated return was filed by the parent or principal reporting corporation in the office of the collector of the district in which it had its principal office. Each of the other affiliated corporations filed in the office of the collector of its district Form 1122, along with the several schedules indicated thereon. The parent or principal corporation filing a consolidated return included in such return a statement specifically setting forth (a) the name and address of each of the subsidiary or affiliated corporations included in such return, (b) the par value of the total outstanding capital stock of each of such corporations at the beginning of the taxable year, (c) the par value of such capital stock held by the parent corporation or by the same interests at the beginning of the taxable

179 Cf. Revenue Act of 1921, § 240 (c); Revenue Act of 1918, § 240 (b). See also Revenue Act of 1921, § 240 (d) and p. 258.

180 Cf. Revenue Act of 1921, § 240 (b); Revenue Act of 1918, § 240 (a).

181 The treasury department's practice of requiring consolidated excess-profits tax returns for 1917 has now been validated (Revenue Act of 1921, § 1331). See footnote 209.

year, (d) in the case of affiliated corporations owned by the same interests, a list of the individuals or partnerships constituting such interests, with the percentage of the total outstanding stock of each affiliated corporation held by each of such individuals or partnerships during all of the taxable year, and (e) a schedule showing the proportionate amount of the total tax which it is agreed among them is to be assessed upon each affiliated corporation.[182] The treasury department greatly preferred that the parent or principal reporting corporation take up and pay the entire tax, making any desired adjustments thereof by charging the affiliated corporations through their own records. The amount reported by the subsidiary on Form 1122 as apportioned to it was used as the basis of assessment and payment. If the subsidiaries reported an apportionment in this manner, but the parent corporation had paid the tax installments on account of such subsidiaries, an amended Form 1122 was required to be filed showing "none" in answer to the question as to the amount of tax apportioned to it. If the last condition obtained, but the taxpayer insisted upon apportionment the collector of the subsidiary's district would request abatement of such portion of the subsidiary's tax as might have been previously paid by the parent corporation in another district. As a basis for such advice, the latter collector secured from the parent corporation a schedule showing apportionment of the total tax and installments to the respective affiliated corporations. If a subsidiary filed a tentative return and paid an installment of the tax, it was assessed the amount shown on Form 1122, and paid future installments as they fall due.[183] Foreign corporations and personal service corporations were not permitted to file consolidated returns.[184]

[182] Reg. 45, Art. 632.

[183] Mimeograph letter to collectors, I. T.—Mim. 2221 dated August 8, 1919; I. T. S. 1919, ¶ 3570.

[184] Revenue Act of 1918, § 240. The English Finance Act of 1915 provided for the consolidated assessment of the excess profits duty in the case of affiliated companies carrying on the same trade or business. Before the regulations under the 1917 American Law were issued the American Institute of Accountants advocated the assessment of federal corporate taxes upon the basis of consolidated returns in a brief, of which the following is an extract: "If the rule which we advocate (consolidated returns) be adopted the tax will be based on the real facts and determined by the relation between true income and the true investment of the group of companies as a whole; and the latter course (consolidated returns) would impose no additional burdens on anyone, since it is the course followed for all practical purposes by the corporations themselves and recognized by

Affiliated Corporations. The provision[185] of the Revenue Act of 1918 (and the Revenue Act of 1921) requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, a consolidated return is necessary in order that the invested capital and net income of the entire group may be accurately determined. Otherwise taxation may be evaded by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation may be imposed as a result of purely artificial conditions existing between corporations within a controlled group.[186]

WHEN CORPORATIONS ARE AFFILIATED.[187] Corporations will be deemed to be affiliated (a) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" cannot be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95% or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated re-

bankers, economists and accountants as the only course which reveals the true situation." (Journal of Accountancy, January, 1919.)

[185] Revenue Act of 1921, § 240; Revenue Act of 1918, § 240.

[186] Reg. 45, Art. 631.

[187] The same corporations affiliated within the meaning of the rulings discussed in this paragraph will be affiliated within the meaning of the Revenue Act of 1921.

turns may, however, be required even though the stock ownership is less than 95%. When the stock ownership is less than 95%, but in excess of 50%, a full disclosure of affiliations should be made, showing all pertinent facts, including the stock owned in each subsidiary or affiliated corporation and the percentage of such stock owned to the total stock outstanding. Such statement should preferably be made in advance of filing the return, with a request for instructions as to whether a consolidated return should be made. In any event such a statement should be filed as a part of the return.[188] If the stock ownership is less than 95%, corporations will not be deemed to be affiliated unless there are revealed inter-company operating transactions or an artificial inter-corporate relationship. A 51% stock control will not infrequently present such conditions; a 69% control will be insufficient, without such conditions, to authorize a consolidated return.[189] Where practically all the stock of one corporation is owned by another corporation, but the latter corporation has deposited the same with an independent trust company under an escrow agreement as collateral security to secure its preferred stockholders in the redemption of their stock, and the independent trust company has legal title to the stock for the benefit of such preferred stockholders with full and irrevocable right, power and authority during the existence of such preferred stock to vote the stock held by it, the two corporations are not affiliated. The mere equity of the corporation formerly owning the stock is not a direct ownership and the irrevocable voting power of the trust company obviates any control.[190]

The words "the same interests" will be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned by two or more individuals or by two or more partnerships, a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.[191] On ac-

[188] Reg. 45, Art. 633.

[189] A. R. R. 448, T. B. 14-21-1553. This was held in spite of the cumulative voting provisions of the Ohio statutes and other provisions that a majority of the board of directors which could be elected by the 69% interest might select officers, and that a 60% interest might exercise practically all important corporate powers.

[190] A. R. R. 641, T. B. 43-21-1883.

[191] Reg. 45, Art. 633. The ruling on this point should be the same under the 1921 Law. In the case of two corporations, one owning and operating property in the Hawaiian Islands, the other owning and leasing various pieces of property in California, the stock of the California corporation was

count of the disparity of holdings of the stockholders in the corporations the treasury department would be unable in such cases to compel the corporations to pay a tax based upon a consolidated return, provided the corporations failed to pay such tax voluntarily. Corporations will not be permitted to do what they could not be required to do. Thus, an application to make a consolidated return has been denied in the case of two companies when 24.26% of the stock of the first company was owned by individuals who held no stock whatever in the second company, and more than 6% of the stock of the second company was held by individuals who held no stock whatever in the first company.[192] Where 19% of the stock of a corporation is owned by minority interests, 13% of which is owned unconditionally by one of the officers and where 39% of the stock of another corporation is held by minority interests, 10% of which is held unconditionally by a different officer, and in each instance the officer has no other interest in the otherwise controlled corporations, there should be no consolidation.[193] In a recent case a

held by the members of one family—four male members of the family, each owning five-twenty-fourths, and a sister one-sixth of the entire stock; and the stock of the Hawaiian Corporation was held by the same family principally, with the exception that one-sixth of the stock was held by each of the four male members aforementioned, one-sixth by the sister aforementioned, and one-sixth by the husband of a deceased sister to the other stockholders. Although the affairs and operations of the two corporations were always actively conducted by and in the control of the male members of the family, and although the two corporations were in purpose and effect only one enterprise, the treasury department has ruled that the holdings of the two companies were not so substantially in the same proportions as to require a consolidated return, and that these two corporations should file separate returns. (Letter from treasury department dated April 11, 1919, I. T. S. 1921, ¶ 2051.)

192 T. B. M. 32, T. B. 7-19-304; T. B. R. 521, T. B. 16-19-465. It is questionable whether this ruling is correct. Sec. 240 (b) provides as follows: "For the purpose of this section, two or more domestic corporations shall be deemed to be affiliated * * * (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests." The substantial effect of the ruling is to add the following words to the statute: "*provided that the percentage of stock held by each individual or partnership is substantially the same in each of the corporations.*"

193 A. R. R. 378, T. B. 5-21-1421. Neither of the two above officers were related by blood or marriage, a relationship which may be an important consideration. Inter-company loans upon which 6% interest was charged and the fact that one of the companies sold to the other two on the basis of cost plus handling charges were held not to affect the conclusion stated in the text above, the other two corporations selling to the first at market prices. A contract by which certain stockholders of the three companies, including the officers above mentioned, agreed to assume liability in propor-

corporation, the majority of whose stock was owned by its president and manager, turned over a branch of its business to a new company not incorporated, the president and manager of the corporation retaining control of the new company. There was no transfer of corporate assets. The new company simply used the assets of the corporation without consideration of any kind, but was operated as a separate enterprise. The treasury department held the new company to be merely a branch of the corporation and not a separate entity, with the result that its income was required to be included in the return of the corporation.[194]

CHANGE IN OWNERSHIP DURING TAXABLE YEAR. When one corporation owns substantially all the stock of another corporation at the beginning of any taxable year, but during the taxable year sells all or a majority of such stock to outside interests not affiliated with it, or when one corporation during any taxable years acquires substantially all the capital stock of another corporation with which it was not previously affiliated, a full disclosure of the circumstances of such changes in ownership must be submitted to the commissioner. In accordance with the peculiar circumstances in each case the commissioner may require separate or consolidated returns to be filed, to the end that the tax may be equitably assessed.[195]

CORPORATION DERIVING CHIEF INCOME FROM GOVERNMENT CONTRACTS. In the case of any affiliated corporation organized after August 1, 1914, and not a successor to a then existing business, 50 per cent. or more of whose gross income consists of gains, profits, commissions, or other income derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, the net income and invested capital of such corporation will be taken out of the consolidated net income and invested capital of the group of affiliated corporations and the corporation so segregated will be separately assessed on the basis of its own invested capital and net income, the remainder of such affiliated group being assessed on the basis of the remaining consolidated invested capital and net income.[196] The income of affiliated corporations which is

tion to stockholdings to protect certain endorsements given on notes the proceeds of which had been received by the corporations was also held immaterial, particularly in view of the fact the stockholdings had changed since the making of the agreement.

194 O. D. 467, T. B. 16-20-866.

195 Reg. 45, Art. 634.

196 Reg. 45, Art. 635.

derived from government contracts is taxable upon the basis of the total sum received from that source by the group and not upon the basis of the separate amount received by each corporation.[197]

Domestic Corporation Affiliated With Foreign Corporation Under 1918 Law. A domestic corporation which owns a majority of the stock of a foreign corporation will not be permitted or required, under the 1918 law, to include the net income or invested capital of such foreign corporation in a consolidated return,[198] but a domestic corporation which owns a majority of the voting stock of a foreign corporation is entitled under that law to credit its income, war-profits and excess-profits taxes with any income, war-profits or excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States in an amount equal to the proportion which the amount of any dividends received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid. But in no such case may the amount of the credit for such taxes exceed the amount of such dividends received by such domestic corporation during the taxable year.[199] The rule with regard to the affiliation of domestic and foreign businesses under the present law is stated in the next paragraph.

Affiliation of Related Trades or Businesses. A new subdivision is added to the provision for the filing of consolidated returns by affiliated corporations giving the commissioner power to consolidate the accounts of two or more closely related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) for the purpose of making an accurate distribution or apportionment of gains,

[197] O. D. 415, T. B. 12-20-799.

[198] Where a New Jersey corporation owned all of the outstanding stock in a foreign corporation which in turn owned all of the outstanding stock in a New York corporation, the treasury department required the two domestic corporations to file a consolidated return, excluding the foreign corporation. (Letter from treasury department dated April 23, 1919; I. T. S. 1921, ¶ 2056.)

[199] Reg. 45, Art. 636; T. B. R. 36, T. B. 11-19-388. A domestic corporation seeking such credit must comply with those provisions of subdivision (a) of Reg. 45, Art. 383, which are applicable to credits for taxes already paid, except that in accordance with Article 611 the form to be used is Form 1118 instead of Form 1116.

profits, income, deductions, or capital between or among such related trades or businesses.[200] The official explanation of this provision is that it "is necessary to prevent the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized as foreign trade corporations."[201]

CONSOLIDATED NET INCOME OF AFFILIATED CORPORATIONS. Subject to the provisions governing the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions, the consolidated taxable net income will be the combined net income of the several corporations consolidated, except that the net income of corporations deriving their chief income from government contracts will be taken out. In respect of the statement of gross income and deductions and the several schedules required under Form 1120, a corporation filing a consolidated return is required to prepare and file such statements and schedules in columnar form to the end that the details of the items of gross income and deductions for each corporation included in the consolidation may be readily audited.[202]

DIFFERENT FISCAL YEARS OF AFFILIATED CORPORATIONS. In the case of all consolidated returns, consolidated invested capital must be computed as of the beginning of the taxable year of the

200 Revenue Act of 1921, § 240 (d). It is a question whether this provision takes effect as of January 1, 1921 (see § 263) or January 1, 1922, when the remainder of the consolidated returns provision takes effect.

201 See Report of Senate Finance Committee on Internal Revenue Bill of 1921, p. 20. See also Report of Committee on Ways and Means, p. 14, in which it is said of § 249, (240 (d)): "Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to 'milk' the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company. To prevent this abuse, § 249 (240), would give the Commissioner of Internal Revenue power to consolidate the accounts of two or more related trades or businesses solely for the purposes of making an accurate distribution of gains, profits, income, deductions, or capital and not for the purpose of computing the tax on the basis of the consolidated return."

202 Reg. 45, Art. 637. A consolidated return for federal tax purposes is to be distinguished from a consolidated statement for submission to stockholders. This is because, among other things, a foreign corporation will not be deemed to be affiliated with a domestic corporation (Reg. 45, Art. 636), nor will a corporation 50% or more of whose gross income was derived from government contracts made between April 6, 1917, and November 11, 1918, be deemed to be an affiliated corporation (Reg. 45, Art. 635). Moreover, in the case of two companies, one of which holds between 50% and 95% of the stock of the other, a consolidated return might not be required by the treasury department.

parent or principal reporting company and consolidated income must be computed on the basis of its taxable year.[203] Whenever the fiscal year of one or more subsidiary or other affiliated corporations differs from the fiscal year of the parent or principal corporation, the commissioner should be fully advised by the taxpayer in order that provision may be made for assessing the tax in respect of the period prior to the beginning of the fiscal year of the parent or principal company.[204] In any case where an affiliated corporation has made its income tax return on the basis of a taxable year different from that on the basis of which a consolidated excess-profits tax return in which it is included has been made, an amended income tax return may be made on the basis of the same taxable year as the consolidated return, even though notice was not given within the time prescribed.[205] In such case an amended income tax return should also be made for any unaccounted for portion of the corporation's taxable year.[206]

Liberty Bond Exemption in Case of Affiliated Corporations. In case of consolidated returns, affiliated corporations are treated as if they were not affiliated and each corporation is entitled to the same full benefits under the exemption provisions of the several Liberty Bond Acts to which it would be entitled if separate returns were made.[207]

Claims for Credit or Refund. A claim for credit or refund of excess tax paid by one of affiliated corporations can be made only by the corporation entitled to receive such credit or refund. With respect to refunds, credits, and additional assessments each affiliated corporation occupies a status similar to that of an independent and unaffiliated corporation. An additional tax assessed for the year 1918, on the basis of the consolidated return for that year, must be apportioned among affiliated corpo-

203 Letter from treasury department dated May 20, 1919; I. T. S. 1921, § 2044. Under the Act of October 3, 1917, it was held that the consolidated return should be made on the basis of the fiscal year of the parent company. As to past periods, the income of subsidiaries was to be computed to the date of the fiscal year of the parent company, and where the accounts did not disclose the profits earned as of such dates, estimates were accepted subject to a correct accounting at the close of the succeeding year. (Letter from treasury department dated March 23, 1918; W. T. S. 1918, ¶ 913.)

204 Reg. 45, Art. 638.

205 Reg. 33 Rev., Arts. 211-215; Reg. 45, Art. 26; See Reg. 41, Arts. 77 and 78; T. D. 2662.

206 T. D. 2805.

207 Letter from treasury department dated May 21, 1919; W. T. S. 1921, ¶ 736, ¶ 1046; revising letter from treasury department dated April 5, 1919; W. T. S. 1919, ¶ 1038; letter from treasury department dated April 16, 1919, ¶ 1039; T. B. R. 7, T. B. 2-19-171. See Chapter 18.

rations, and to the extent that each debtor corporation is entitled to receive back a part of taxes paid in prior years, a claim for credit may be filed and the amount of additional tax each subsidiary is required to pay may be reduced thereby by the amount it is entitled to receive. In case the amount payable to the subsidiary exceeds its proportionate part of the additional tax assessed under the consolidated return, it may file a claim for refund for the difference.[208]

PREPARATION OF CONSOLIDATED BALANCE SHEETS. In the preparation of consolidated balance sheets it is extremely important (1) to reconcile inter-company current accounts, allocating any differences to the proper asset or liability account, which includes the surplus or undivided profits account in case of the adjustment of income or expense items, (2) to eliminate inter-company holdings of capital stock, (3) to eliminate the surplus of the subsidiary companies when the capital stock thereof was purchased by the parent or holding company, for an amount equal to, or greater than, the par value of the capital stock plus the surplus of the subsidiary companies at the date of such purchase. When the book value of a subsidiary company in the balance sheet of the holding or parent company is greater than the par value of the stock plus the surplus of the subsidiary at the time of acquisition, the excess should be charged to good will. When it is less, the difference should be credited to surplus, unless there is good will of a greater amount either (1) on the accounts of the holding or parent company or of the subsidiary company, or (2) arising from purchases of stocks of other subsidiary companies. If good will is not shown separately, the debits and credits should be made to the account in which good will is included, instead of to good will or surplus. Where one company does not own the entire capital stock of a subsidiary company, it is customary to show the capital stock of the subsidiary company plus the surplus attributable thereto, owned by other stockholders on the consolidated balance sheet as a distinct obligation to such stockholders. Inventories in consolidated accounts should be carefully scrutinized and adjustments made eliminating any inter-company profits reflected therein.

Consolidated Returns Under the 1917 Law. For the year 1917 affiliated corporations and partnerships were permitted or required to file consolidated returns for the purpose of the excess-profits tax. Some doubt exists concerning the legality of this procedure and in order to set all doubts at rest provision is made in the Revenue Act of 1921 validating the practice of the treas-

[208] O. D. 683, T. B. 41-20-1237.

ury department in this respect under that law.[209] The present law provides that a corporation, or partnership, was affiliated within the meaning of the 1917 law "with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital." Public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, are not affiliated; but a railroad or other public utility which was

[209] Revenue Act of 1921, § 1331. See Report of Committee on Ways and Means on Revenue Bill of 1921, p. 16; Report of Finance Committee, p. 34. The fact that one corporation held the entire capital stock of another and that the two were component parts of one business unit or system did not ordinarily, under the 1916 Law, destroy the separate entities of the two corporations. As a general rule corporations as such were subject to the tax, not the business organizations of which the corporations might be a part. Every corporation was considered to be a distinct entity regardless of its relation to any other corporation. Where a parent corporation owned all or practically all of the stock of subsidiary companies, each was required to make a return accounting in detail for their separate gross incomes and deductions, and each was generally required to pay the tax on the net earnings shown by such return. The parent company was not permitted to report the gross income of all subsidiaries and deduct therefrom the gross expenses. (T. D. 2137; T. D. 2090.) The net earnings of the subsidiary companies turned over to the parent company were to be treated as dividends, notwithstanding the earnings out of which the dividends were paid were also subject to tax, as against the subsidiary companies. In U. S. v. Nipissing Mines Co., 206 Fed. 431, 234 U. S. 765, decided under the 1909 Law, it was held that although the affairs of the holding and operating company were closely connected and they had officers in common, the distinct corporate existence of each should not be ignored and the holding company should not be treated as being engaged in the business of the operating company. It was held in an early ruling that the fact that a corporation had a number of subsidiaries only for the purpose of protecting trade brands, trade marks and trade names was immaterial; that the liability to make separate returns attached to each subsi-

owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, are affiliated.[210]

Special Returns of Corporations. In addition to the above mentioned returns required to be filed by every corporation not exempt from tax, several special returns are required annually or at such times as the commissioner may request of every corporation.

REPORT OF DIVIDEND PAYMENTS. Every corporation, including a personal service corporation, when requested by the commissioner, is required to render a correct return of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends

diary company by reason of the fact that it was a separate and distinct entity. If such subsidiary had no net income or earnings and no expense of operations, and if the earnings accrued direct to the parent company, which also paid direct the operating expenses of the subsidiaries, those facts should be set out in the return of the subsidiary, but they did not operate to release the subsidiary from liability to make a return. (T. D. 2161.) If subsidiary corporations existed in name only, or were mere agents or integral parts of the parent corporation and as such, transacted no business and had no income of and for their own account, and incurred no expenses, all business being transacted, all income being received and all expenses being paid directly by the parent company, no separate accounts being kept by or for such subsidiaries, it was considered that such subsidiary concerns had no taxable income. In such cases, however, such subsidiary corporations were required to make returns and indorse thereon a statement to the effect that the corporation making the return was a subsidiary or integral part of the parent company (naming it) and that, for its own account, it had no income from any source whatever, that it made no disbursements, and that all the business done in its name was done for the account of and was the business of the parent corporation, and would be accounted for in the return of such parent corporation. This ruling (Reg. 33 Rev., Art. 208) was not intended to cover those subsidiary corporations which actually transacted business in their own names, received income for their own account, which incurred and paid expenses incident to the production of such income, which kept separate books of account, and which, as separate entities, exercised all the powers and functions authorized by their charters. Corporations of this character were required to pay the income tax on the net income received by them from all sources, regardless of the fact that such net income was paid or turned over to a parent or holding company, by whom it was also returned for the purpose of the tax.

[210] Revenue Act of 1921, § 1331; T. D. 2662; Reg. 41, Arts 77, 78; Letter from treasury department dated April 17, 1919; I. T. S. 1921, ¶ 2049; A. R. R. 123, T. B. 22-20-976; A. R. R. 624, T. B. 38-21-1834; A. R. R. 641, T. B. 43-21-1888.

paid to him.[211] This return is for the purpose of supplying the government with information with which the returns of stockholders may be compared, and is more fully discussed in another chapter.

Report of Income Payments. All corporations, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries[212] and employers, making payment to any individual, corporation or partnership of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income (other than dividends and the payments described in the following paragraph) of $1,000 or more in any taxable year, are required to make returns in regard thereto to the commissioner, setting forth the amount of such payments and the names and addresses of the recipients. In the case of payments of interest upon its bonds, mortgages or deeds of trust or other similar obligations, such return is required from a corporation regardless of the amount paid.[213] This return is for the purpose of supplying the treasury department with information to be used in auditing the returns of the taxpayers to whom the income is paid, and is more fully discussed in a later chapter.[214]

Reports by Brokers. Every corporation doing business as a broker[215] is required, when called upon by the commissioner, to make a return showing the names of its customers with such details as to the profits, losses or other information which the commissioner may require, as to each of such customers, as will enable the commissioner to determine whether all income tax due on the profits or gains of such customer has been paid.[216] This report is for the purpose of information at the source and is more fully discussed in a later chapter.[217]

Payment of the Tax. Ordinarily the tax of corporations is paid in the same manner and subject to the same rules as the tax of

211 Revenue Act of 1921, § 254; Revenue Act of 1918, § 254. See the definition of the term "dividend" in § 201.

212 See Chapter 39. It will be noted in this provision the Commissioner is given discretion to require or not to require such returns.

213 Revenue Act of 1921, § 256; Revenue Act of 1918, § 256.

214 See Chapter 39.

215 The Revenue Act of 1921 and the Revenue Act of 1918 omit the clause defining brokers, "on any exchange or board of trade or other similar place of business," which appeared in the 1916 Law.

216 Revenue Act of 1921, § 255; Revenue Act of 1918, § 255.

217 See Chapter 39. It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns.

individuals.[218] Certain special rules applicable to the payment of the tax by corporations are set forth in the following paragraphs.

LIABILITY FOR TAX AFTER DISSOLUTION. When a corporation is dissolved its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. Any sales of property by them are to be treated as if made by the corporation, for the purpose of ascertaining the gain or loss. Any profit or loss resulting from the sale of capital assets by the trustees or receiver during the process of liquidation is to be merged with the profit or loss resulting from the regular business of the corporation during the same taxable year prior to the taking over of the affairs of the corporation by the trustees or by the receiver.[219] No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition.[220]

218 See Chapter 35.

219 Letter from treasury department dated October 24, 1919; I. T. S. 1921, ¶ 1031.

220 Reg. 45, Art. 547; In re Heller Hirsh & Co., 258 Fed. 208. See also Reg. 33 Rev., Art. 205; Reg. 33, Art. 85; T. D. 2209; T. D. 2090. Where the officers and directors (being all the stockholders) of a manufacturing company had for many years fraudulently converted to their own use as dividends sums which should have been paid to the government as taxes, and where the company had become insolvent and a sale of the company's property did not satisfy the government's lien, it was held that there is jurisdiction in equity, on the ground of inadequacy of remedy at law, for the appointment of a receiver and for impounding the company's tangible and intangible assets, wrongfully in the hands of the stockholders, and applying them to the payment of the company's obligations to the government. It was not necessary that the government first obtain a judgment. (United States v. Capital City Dairy Co., 252 Fed. 900.) It was held on demurrer under the Corporation Excise Tax Law of 1909 that a corporation could not evade liability for the tax by dissolving before the time when it was required to make a return. (U. S. v. General Inspection & Loading Co., 192 Fed. 223.) When the same case came before the court for trial, it was held that notice addressed to the defendant at the place of its principal office at the time of its dissolution, presumptively received, was sufficient to warrant the collection of penalties (204 Fed. 657). Corporations which were dissolved in 1917, prior to the passage of the 1917 law, were held subject to tax under the 1916 law, as amended, and also under the 1917 law. A corporation so situated was required to make a return covering the period in 1917 during which it was in business prior to its dissolution. If it should previously have made a return covering this period and paid any excess-profits tax under the act of March 3, 1917, it credited the amount of such tax against any excess-profits tax assessable against it under Title II of the act of

Collection of Tax From Assets. The Revised Statutes,[221] as amended, provide generally with reference to internal revenue taxes that: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment list was received by the collector, except when otherwise provided, until paid, with the interest, penalties and costs that may accrue in addition thereto, upon all property and rights belonging to such person." The present law and the Revenue Act of 1918 provide[222] that "all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this act." The condition to the above lien, which gives the government a preference over general creditors, is a receipt of an assessment list by the collector. When returns under the 1918 law were received at the collector's offices, they were examined and listed before being forwarded to the commissioner. If it appeared that the tax was greater or less than shown in the return, the tax was recomputed. After checking the figures the commissioner assessed the tax on the basis of the collectors' lists. The collectors then sent out bills for the taxes, either as computed by the taxpayer or as recomputed.[223] This procedure is different from the procedure under the 1916 law. Under that law it was the duty of the commissioner to send to each collector a list of the companies liable for tax in his district, showing the amounts for which they were liable within such time that the collector might give the required notice of assessment on or before June 1 and upon such lists the collections were made. The present law, except with regard to a "tax or deficiency" discovered upon examination of a return, does not seem to require any different procedure from that adopted under the 1918 law.

Under the provision of the Revised Statutes above quoted the lien was fixed upon the assets of the corporation when this list came into the collector's hands. It is doubtful whether the commissioner's assessment under the Revenue Act of 1918 "upon the basis" of the collectors' lists constituted a technical compli-

October 3, 1917. (Reg. 33 Rev., Art. 61.) This ruling was made on authority of Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654. (See letter from treasury department dated November 17, 1917; I. T. S. 1918, ¶ 1085).

221 R. S., § 3186.

222 Revenue Act of 1921, § 1300; Revenue Act of 1918, § 1305.

223 Reg. 45, Art. 1012.

ance with the above provision of the Revised Statutes giving a lien, unless the commissioner after his assessment forwarded lists to the collectors which were "received" by them. When additional taxes were assessed under the Revenue Act of 1918, lists containing the names of taxpayers liable to such additional taxes and the amounts thereof were forwarded to the collectors from time to time. The government's lien, with respect to these additional taxes, commenced when these lists were received by the collectors. Under the present law this practice in regard to additional taxes—"a tax or a deficiency in tax"—will probably be continued. If a corporation has distributed all of its assets and become dissolved prior to the time when the list carrying an assessment against it is received by the collector, the tax is not collectible upon notice and demand followed by distraint.[224] The corporation is not in existence; it has distributed its assets before any lien attached to them. No personal liability for additional taxes will ordinarily be incurred by the officers of a corporation or liquidating agents in charge thereof on the distribution of the assets of the corporation, provided they have paid all taxes theretofore assessed.[225]

NOTICE OF LIEN. The government's lien is not valid as against any mortgagee, purchaser or judgment creditor unless perfected as outlined in another chapter.[226]

RECOVERY AGAINST STOCKHOLDERS. Although the statutes provide for a lien, this particular remedy for collecting the tax is not exclusive, and the government may resort to the common-law method of collecting the same.[227] The dissolution of a corporation does not extinguish its liabilities and through the courts of equity creditors may pursue its assets into the hands of any person who is not a *bona fide* purchaser. The sale of the entire capital stock of a corporation and the distribution of the proceeds of the sale among the stockholders will not defeat or impair the remedy of creditors, if any debts remain unpaid, as the creditors in that event may pursue the proceeds of the sale in the hands of the respective stockholders and compel each one to contribute *pro rata* toward the payment of the debts to the extent of the moneys received on the distribution.[228] This remedy is open to the government in the same manner as it is to any

[224] O. D. 769, T. B. 1-21-1378.
[225] O. D. 863, T. B. 16-21-1583.
[226] See Chapter 35.
[227] Dollar Savings Bank v. U. S., 19 Wall. 227.
[228] Railroad Co. v. Howard, 7 Wall. 392.

other creditor for the collection of the tax,[229] but not for collection of the penalty for failure to file returns.[230] Where a Montana corporation sold all its property and distributed the proceeds to the stockholders and became dissolved, the additional tax imposed by the Revenue Act of 1916 retroactively from January 1, 1916, to the date of dissolution may be collected from the stockholders to whom the corporate assets have been distributed.[231] If certain of the stockholders are without assets and fail to pay their pro rata share, the remaining stockholders are responsible for the payment of the tax to the extent of the value of the assets of the corporation received by them regardless of their pro rata share under the principle known as the "trust fund" doctrine in respect of corporations.[232]

Reorganization Prior to Attachment of Lien. In cases where corporations liable for additional taxes, not yet assessed and paid, dispose of their assets as an incident of a reorganization, the liability of the new corporation may depend largely on the form of the transaction. Upon such a reorganization the new corporation may acquire the stock of the old corporation in exchange for its own stock and then dissolve the old corporation, taking over all its assets. In that case the new corporation is the stockholding distributee of the corporate assets of the old corporation, and is liable to the extent of the value of the assets so received. On the other hand, the new corporation may purchase the assets of the old, paying therefor in its own stock, in which event it does not stand in the position of a stockholder receiving a dividend in liquidation. If there is an agreement to assume the liabilities of the old corporation, it may be that the new corporation is liable to a greater extent than the value of

229 O. D. 769, T. B. 1-21-1378; O. D. 883, T. B. 16-21-1583; 28 Op. Atty. Gen. 241. See U. S. v. Capital City Dairy Co., 252 Fed. 900 and Note 220.

230 T. D. 1852. In the case of U. S. v. General Inspection and Loading Co., 192 Fed. 223, 204 Fed. 657, judgment was entered for tax, penalty for delay in the payment of the tax, and interest, under the 1909 Law, notwithstanding the fact that the corporation had been previously dissolved. But in this case the assets had not been distributed.

231 U. S. v. McHatton, 266 Fed. 602; T. D. 3043, T. B. 29-20-1078; O. D. 597, T. B. 29-20-1079; A. R. R. 43, T. B. 12-20-794. In the McHatton case the court said: "Although taxes are not debts, and in respect to them the government is not a creditor, both being of higher nature, no reason is perceived why they are not within the principle that those who gratuitously take all a debtor's property, to the extent thereof, may be held to respond for his present debts and obligations, inchoate or vested, or for the damages thereby inflicted—the sometime 'trust fund' doctrine, so far as corporations are concerned." See also O. D. 75, T. B. 1-19-107.

232 O. D. 707, T. B. 43-20-1269.

the property or assets received. But in the absence of such an assumption it would seem that the liability of the new company would be limited to the value of the assets received. It is doubtful whether there can be any liability in excess of the assets received, on the theory of novation. Whether or not the government has a prior claim on the assets of the new corporation for the satisfaction of a contractual liability arising from an agreement to assume the liabilities of the old company or otherwise is not clear, although some federal cases seem to point to such priority.

Abatement and Refund. The principles controlling abatement and refund of taxes claimed from or paid by corporations are generally the same as those applying to individuals and are treated in another chapter.[233] It has been held with regard to claims for credit in the case of corporations that under the statutes of New Jersey providing for a merger or consolidation of corporations resulting in the formation of another corporation, which in effect shall represent predecessor corporations in the enforcement of their rights, the successor corporation is entitled to file a claim for credit on account of overpayment of taxes by the predecessor corporation.[234]

Withholding the Tax at the Source. No withholding takes place on payment of income to domestic corporations. Such corporations are required to withhold the tax on payments of fixed or determinable and annual or periodical gains, profits and income to nonresident aliens, and nonresident foreign corporations and on payment of bond interest as indicated in another chapter.[235]

Foreign Items. Corporations undertaking as a matter of business and for profit the collection of foreign items are required to obtain a license in the manner more particularly set forth in another chapter.[236]

Examination of Corporate Records. All corporate books, papers, records or memoranda are subject to examination by any revenue agents or inspectors designated by the commissioner for the purpose of ascertaining the correctness of returns which have been made, or making a return where none has been made, in

[233] See Chapter 37.

[234] O. D. 950, T. B. 24-21-1690.

[235] See Chapter 40. Under the 1916 Law, as amended, corporations were required to withhold the tax on dividend payments to non-resident foreign corporations, but this is no longer required.

[236] Revenue Act of 1921, § 259; Revenue Act of 1918, § 259. See Chapter 40.

accordance with and subject to certain rules which are discussed at length in another chapter.[237]

Penalties. Corporations or their officers or employees are subject in certain cases to penalties, both specific and *ad valorem,* for failing or refusing to make returns, supply information, pay or collect any tax or for willfully attempting in any manner to defeat or evade the tax. Such penalties are more particularly discussed in another chapter.[238]

Personal Service Corporations. Personal service corporations,[239] as such, were not subject to the tax imposed by the Revenue Act of 1918, and the tax imposed by the present law for the year 1921, their individual stockholders being taxed in the same manner as the members of partnerships. After December 31, 1921, they are taxable in the same manner as other corporations.[240]

Transportation Systems. For the purpose of the act[241] providing for the operation of transportation systems while under federal control four-fifths of the tax—or a tax of 8%—on the net income of corporations in excess of credits for the calendar year 1919 and each calendar year thereafter, is treated as levied by an act in amendment of Title I of the Revenue Act of 1917.[242] The act providing for the operation of transportation systems while under federal control and for the just compensation of their owners provided that every agreement entered into pursuant thereto between the President and the transportation systems covering the operation thereof while under federal control and the just compensation of the owners thereof should provide that any federal taxes "under the act of October third, nineteen hundred and seventeen, or acts in addition thereto or in amendment thereof, commonly called war taxes," assessed for the period of federal control beginning January 1, 1918, or any part of such period, should be paid by the carrier out of its own funds or charged against or deducted from the just compensation stipulated in the agreement. Other taxes assessed under federal or any other governmental authority for the period of federal control or any part thereof either on the property used or on

237 See Chapter 38. This chapter also discusses the new provision of the Revenue Act of 1921 against unnecessary examinations or investigations.

238 See Chapter 36.

239 The subject of personal service corporations is treated in full in Chapter 9.

240 Revenue Act of 1921, § 218; Revenue Act of 1918, § 218.

241 Act of March 21, 1918.

242 Revenue Act of 1918, § 230 (b). For the calendar year 1918 five-sixths of the tax—or a tax of 10%—was so treated.

the right to operate as a carrier or on the revenues or any part thereof derived from operation (not including, however, assessments for public improvements or taxes assessed on property under construction and chargeable under the classification of the interstate commerce commission to investment in road and equipment) were provided to be paid out of revenues derived from railway operations while under federal control. All taxes assessed under federal or any other governmental authority for the period prior to January 1, 1918, whenever levied or payable were provided to be paid by the carrier out of its own funds or charged against or deducted from the just compensation. The 4% tax levied under the 1917 law was paid by the carrier out of its own funds or charged against or deducted from the compensation payable to the carrier, whereas the 2% tax imposed by the 1916 law was paid out of revenues derived from railway operations while under federal control. The tax on all income payable by the carrier on its income taxable under the Revenue Act of 1918 in excess of the 2% levied under the 1916 law was accordingly to be paid by the carrier out of its own funds or charged against or deducted from any compensation it may receive by reason of government operation since such excess is treated as levied by the act in amendment of "the act of October third, nineteen hundred and seventeen or acts in addition thereto or in amendment thereof, commonly called war taxes".[243]

[243] Act of March 21, 1918; Reg. 45, Art. 504. This act also provides: "That moneys and other property derived from the operation of the carriers during federal control are hereby declared to be the property of the United States. Unless otherwise directed by the President, such moneys shall not be covered into the treasury, but such moneys and property shall remain in the custody of the same officers, and the account thereof shall be in the same manner and form as before the federal control. Disbursements therefrom shall, without further appropriation, be made in the same manner as before federal control and for such purposes as under the Interstate Commerce Commission classification of accounts in force on December 27, 1917, are chargeable to operating expenses or to railway tax accruals and for such other purposes in connection with federal control as the President may direct, except that taxes under Titles I and II of the act entitled 'An act to provide revenue to defray war expenses, and for other purposes,' approved October 1, 1917, or any act in addition thereto or in amendment thereof, shall be paid by the carrier out of its own funds. If federal control begins or ends during the tax year for which any taxes so chargeable to railway tax accruals are assessed, the taxes for such year shall be apportioned to the date of the beginning or ending of such federal control, and disbursements shall be made only for that portion of such taxes as is due for the part of such tax year which falls within the period of federal control."

STANDARD RETURN. In the case of railroads which elected to have their claims for compensation adjusted by a board of referees, or the court of claims, the government does not deny the right to compensation, but the amount of compensation is placed in dispute. In the case of such roads an accrual should be made. The estimated amount that must be accrued in such cases is the so-called standard return.[244]

EXPENSES OF RAILROADS. The following expenditures of railroads constitute an allowable deduction from gross income:

1. Payments for labor and materials going into the actual operation of the road and property.

2. Expenses of maintenance: The upkeep or preserving of the condition of the property to be operated.

3. Expenditures for replacement of old rails with new and heavier rails, wooden bridges and culverts with concrete and steel bridges and culverts, except the excess cost, the deduction being limited to the cost of renewals with like kind and quality.

The following are not deductible:

1. Expenditures for additions and betterments, such as expenditures for sidings or spur tracks.

2. Expenditures for improving and adding to the property, such as building new stations and shops, installing new machinery, and making additions to equipment.[245]

Under the provisions of Section 15a of the Interstate Commerce Act, as amended by the Transportation Act approved February 29, 1920, railroad corporations are required to pay to the Interstate Commerce Commission one-half of their net railway operating income in excess of 6 per cent. on their invested capital. It is understood that such payments are absolute, the railroad company having no present or future rights therein. It has been held that any sum so paid may be deducted in the taxable year in which paid or accrued, dependent upon whether the books of the corporation are kept upon a cash receipts and disbursements or accrual basis.[246]

Telephone Companies. Telephone companies taken over by the government, whose compensation was fixed by the government, were required to include such compensation in gross income, in addition to the income accruing from other sources. Companies whose compensation had not been fixed were required to include in gross income, in addition to other income reported, operating income received, and when, later on, the

[244] O. D. 642, T. B. 34-20-1151.

[245] Grand Rapids Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

[246] O. D. 989, T. B. 32-21-1762.

President fixed the compensation for the use of their properties during the taxable year, such companies filed amended returns showing the total income received and recomputed the tax on that basis.[247] A telephone company was required to make a 1918 return for its accounting period, either calendar or fiscal year, and all income applicable to such period was required to be included in the corporation's return, irrespective of the portion of the year during which it might have been operated under government control.[248]

[247] O. D. 229, T. B. 13-19-404.
[248] O. D. 255, T. B. 15-19-449.

CHAPTER 11

SPECIAL PROVISIONS APPLYING TO INSURANCE COMPANIES

The provisions of the Revenue Act of 1918 applicable to insurance companies (except mutual insurance companies) are completely revised by the Revenue Act of 1921 which provides an entirely new and distinctive scheme of taxation for such companies. This revision was made because the provisions of the 1918 law were regarded as "imperfect and productive of constant litigation", and because it was regarded that the taxes paid by such companies under that law were inadequate. The plan adopted is somewhat similar to the plan embodied in the Revenue Act of 1918, as first adopted by the senate.[1] It takes the place, in the case of *life* insurance companies, of the income tax imposed on other corporations for the calendar year 1921, and also the capital stock tax for that year, and applies for 1921 and each calendar year thereafter, in lieu of such taxes. In the case of insurance companies other than life and mutual insurance companies, the new tax takes the place of the income tax imposed on other corporations for the calendar year 1922, and also the capital stock tax for that year, and applies for 1922 and each calendar year thereafter. Life insurance companies are relieved from the excess-profits tax for the year 1921, while other insurance companies, including life insurance companies, will share with all other corporations in the repeal of the excess-profits tax as of December 31, 1921. Insurance companies other than life insurance companies are, therefore, liable for the excess-profits tax for the year 1921.[2] The effect of the new taxes upon insurance companies with respect to the capital stock tax is discussed in another chapter.[3]

The taxes above referred to are so radically different from the taxes formerly imposed upon such companies that it is thought best to discuss them separately in this chapter. The discussion of the taxes imposed upon insurance companies by the Revenue Act of 1918 will still be applicable and of value for years prior to 1921 in the case of life insurance companies, and for years prior to 1922 in the case of other insurance companies

[1] See Reports of Finance Committee and Ways and Means Committee, respectively, on Revenue Bill of 1921, p. 20, p. 14.

[2] See Revenue Act of 1921, §§ 243, 246 (a).

[3] See Chapter 44.

(except mutual insurance companies), and for all years in the case of mutual insurance companies.

Domestic Life Insurance Companies Under the 1921 Law. The new tax imposed by the present law upon life insurance companies applies only to an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.[4]

RATE OF TAX. The rate of tax imposed upon life insurance companies under the Revenue Act of 1921 is the same as that imposed upon other corporations—10% upon the net income (as defined below) for the calendar year 1921 and 12½% upon such net income for the calendar year 1922 and subsequent years.[5]

GROSS INCOME. The gross income of a life insurance company includes only the gross amount of income received during the taxable year "from interest, dividends, and rents."[6]

DEDUCTIONS IN COMPUTING NET INCOME. The Revenue Act of 1921 specifies a number of deductions which are to be applied in reduction of gross income (as above defined) in the calculation of the net income which is taxable in the case of a life insurance company. These deductions are set forth in the following paragraphs. Many of these deductions are the same deductions which are allowed to ordinary corporations.[7]

INTEREST RECEIVED UPON STATE AND FEDERAL OBLIGATIONS. The following may be deducted by a life insurance company in computing net income:

(1) Interest upon (a) the obligations of a state, territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation; and

(2) An amount equal to the excess, if any, over the deduction specified in (1) of 4% of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering

[4] Revenue Act of 1921, § 242.

[5] Revenue Act of 1921, § 243.

[6] Revenue Act of 1921, § 244 (a).

[7] See Chapter 10 for a discussion of these deductions and the several chapters on the particular deductions.

life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4% of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the commissioner finds to be necessary for the protection of the holders of such policies only.[8]

The term "reserve funds required by law" includes, "in the case of assessment insurance, sums actually deposited by any company or association with state or territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use."[9]

INTEREST PAID. A life insurance company, in computing net income, may deduct from gross income all interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the company) the interest upon which is wholly exempt from income taxation.[10]

DIVIDENDS RECEIVED. The following dividends may be deducted by a life insurance company in computing net income:

(1) Dividends from a domestic corporation other than a corporation entitled to the benefit of being taxable only with respect to income from sources within the United States, and

(2) Dividends from any foreign corporation when it is shown to the satisfaction of the commissioner that more than 50% of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States.[11]

RESERVE FOR DIVIDENDS. An amount equal to 2% of any sums held at the end of the taxable year as a reserve for divi-

[8] Revenue Act of 1921, §§ 245 (a) 12, 213 (b) 4. Interest upon obligations of the United States issued after September 1, 1917, is exempt from the income tax, which is the only one payable after January 1, 1921, by life insurance companies; therefore, such interest is a deduction (See Chapter 18).

[9] Revenue Act of 1921, § 244 (b).

[10] Revenue Act of 1921, § 245 (a) 8. See Chapter 23.

[11] Revenue Act of 1921, § 245 (a) 3. See Chapters 10 and 32.

dends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract, is deductible from the gross income of a life insurance company in computing net income.[12]

INVESTMENT EXPENSES. The investment expenses of a life insurance company are deductible from gross income in computing net income. If any general expenses are in part assigned to or included in the investment expenses, the total deduction for investment expenses can not exceed ¼ of 1% of the book value of the mean of the invested assets held at the beginning and end of the taxable year.[13]

TAXES. In computing the net income of a life insurance company there may be deducted from gross income taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. This deduction is allowed in the case of taxes imposed upon a shareholder or member of a company upon his interest as shareholder or member, which are paid by the company without reimbursement from the shareholder or member, but in such cases no deduction will be allowed the shareholder or member for the amount of such taxes.[14]

No deduction for taxes will be allowed on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value must be not less than a sum which in addition to any rents received from other tenants will provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4% per annum of the book value at the end of the taxable year of the real estate so owned or occupied.[15]

DEPRECIATION. In computing the net income of a life insurance company there may be deducted from gross income a reasonable allowance for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence. In the case

12 Revenue Act of 1921, § 245 (a) 4.

13 Revenue Act of 1921, § 245 (a) 5.

14 Revenue Act of 1921, § 245 (a) 6. See Chapters 10 and 24.

15 Revenue Act of 1921, § 245 (b).

of property acquired before March 1, 1913, this deduction may be computed upon the basis of its fair market price or value as of March 1, 1913.[16]

No deduction for depreciation will be allowed on account of real estate owned and occupied by a life insurance company unless the rental value (computed as indicated in the preceding paragraph) of the space so occupied is included in gross income.[17]

SPECIFIC EXEMPTION. In computing the net income of a (domestic) life insurance company with a net income of $25,000 (without the benefit of this deduction) there may be deducted the sum of $2,000; but if the net income is more than $25,000 the tax imposed upon the company must not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.[18]

Foreign Life Insurance Companies Under the 1921 Law. Foreign life insurance companies are taxable under the Revenue Act of 1921 in the same manner as domestic life insurance companies, except that (1) the tax applies only to their net income from "sources within the United States", and (2) they are entitled to no deduction or exemption of $2,000 (or any exemption in lieu thereof if their net income is more than $25,000).[19] In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States will be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.[20]

Insurance Companies (Other Than Life and Mutual Companies) Under the 1921 Law. The new tax imposed by the present law upon insurance companies (other than life and mutual insurance companies) is at the same rate as that imposed upon other corporations—12½% upon the net income (as defined below) for the calendar year 1922 and subsequent years. The new tax does not affect the calendar year 1921.[21]

16 Revenue Act of 1921, § 245 (a) 7. See Chapters 10 and 26.
17 Revenue Act of 1921, § 245 (b).
18 Revenue Act of 1921, § 245 (a) 9. See Chapter 10.
19 Revenue Act of 1921, §§ 243, 245 (a) 9. See Chapters 4 and 12.
20 Revenue Act of 1921, § 245 (c).
21 Revenue Act of 1921, § 246 (a).

GROSS INCOME. The gross income of insurance companies (other than life and mutual insurance companies) means the combined gross amount, earned during the taxable year, from investment income and from underwriting income as defined in this paragraph, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners.[22]

The "investment income" means the gross amount of income earned during the taxable year from interest, dividends and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year.

The "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year.

The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the results so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and is computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income there must be deducted from such

[22] Revenue Act of 1921, § 246 (b) 1.

expenses incurred all expenses incurred which are not otherwise allowed as deductions.[23]

Deductions in Computing Net Income. The Revenue Act of 1921 allows insurance companies (other than life and mutual insurance companies) deductions for the most part the same as the deductions which are permitted to corporations in general. This is true of (1) ordinary and necessary expenses paid or incurred, (2) taxes paid or accrued, (3) dividends received, and (4) depreciation sustained. The law permits the deduction of "losses incurred", seemingly without the limitations applicable in the case of other corporations. It permits the deduction of bad debts in the nature of agency balances and bills receivable, ascertained to be worthless and charged off within the taxable year. All interest received upon state and federal obligations which is exempt from tax in the case of ordinary corporations, and interest *received* which may be used as a credit for purposes of the income tax may also be deducted, as well as the interest *paid* or accrued which may be deducted by the ordinary corporation. The specific exemption granted to ordinary corporations with a net income (computed without the benefit of the deduction) of $25,000, or less, as a credit, is allowed as a deduction to this class of insurance companies with a net income so computed of $25,000 or less; and if the net income so computed is more than $25,000, the tax on this class of insurance companies may not exceed the tax which would be payable if the credit of $2,000 were allowed, plus the amount of the net income in excess of $25,000. As in the case of all taxpayers there can be no duplication of the above deductions; that is, the same item may not be twice deducted.[24]

Foreign Insurance Companies (Other Than Life and Mutual Companies) Under the 1921 Law. Foreign insurance companies (other than life and mutual insurance companies) are taxable under the Revenue Act of 1921 in the same manner as domestic insurance companies of the same class, except that (1) the tax applies only to their net income from "sources within the United States", and (2) they are entitled to no deduction or exemption of $2,000 (or any exemption in lieu thereof if their net income is more than $25,000). The deductions provided are allowable to such foreign companies only if and to the extent that they are connected with income from "sources within the

[23] Revenue Act of 1921, § 246 (b) 3. These methods are comparable to the calculation of income by the method of inventories. See Chapter 16.

[24] Revenue Act of 1921, § 247 (a). See Chapters 10, 21, 22, 23, 24, 25, 26, and 31.

United States"; and the proper apportionment and allocation of the deductions with respect to sources within and sources without the United States is to be determined as provided in the case of foreign corporations and under rules and regulations prescribed by the commissioner with the approval of the secretary.[25]

Comparison of 1921 and 1918 Laws. Mutual insurance companies (other than mutual life insurance companies) are, in general, taxable under the law in the same manner as ordinary corporations. This applies, for instance, to mutual marine insurance companies. All insurance companies not taxed as indicated in the previous paragraphs, and so taxable as ordinary corporations,[26] are allowed certain deductions under the 1921 law, the necessity for which arises from the peculiar nature of their business.[27] These deductions are substantially the same as the corresponding deductions allowed by the 1918 law. The provision discussed below[28] for a special deduction of the net addition to reserve funds, and sums other than dividends paid on policy and annuity contracts, is applicable only to mutual insurance companies other than life insurance companies, after December 31, 1921, and is of course made inapplicable to life insurance companies for 1921.[29] Otherwise, it is substantially the same as the corresponding provision of the 1918 law. The provision of the 1918 law for a special deduction, in the case of corporations issuing policies covering life, health and accident insurance combined in one policy issued on the weekly premium payment plan, of such portion of the net addition to reserve funds as is required for the protection of policyholders is, of course, made inapplicable to life insurance companies (as defined above) for 1921, and is not applicable at all after December 31, 1921.[30] The provision for a special deduction to mutual marine insurance companies remains the same as under the 1918 law.[31] The provision for a special deduction in the case of mutual insurance companies (other than mutual life or mutual marine insurance companies) of the amount of premium deposits returned to policyholders or retained for the payment of losses, expenses, and reinsurance

[25] Revenue Act of 1918, §§ 234 (b), 246 (a) 2, 247. See Chapters 4 and 12.

[26] This includes all insurance companies except life insurance companies for the year 1921.

[27] See Revenue Act of 1921, §§ 234 (a), 10, 11, 12, 13.

[28] See p. 291.

[29] Revenue Act of 1921, § 234 (a) 10.

[30] Revenue Act of 1921, §234 (a) 11. See p. 294 for a discussion of this deduction.

[31] Cf. Revenue Act of 1921, § 234 (a) 12, Revenue Act of 1918, § 234 (a) 12. See p. 294 for a discussion of this deduction.

reserves, is retained in practically the same form in the present law, but is extended in its application to "interinsurers and reciprocal underwriters".[32] A further provision of the 1918 law that mutual marine insurance companies shall include in gross income "gross premiums collected and received by them less amounts paid for reinsurance" is retained in the 1921 law.[33] The provision of the 1918 law that life insurance companies need not include in gross income "such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premiums of such policyholder within the taxable year" is necessarily omitted from the Revenue Act of 1921.

Insurance Companies Under the 1918 Law. While the remaining discussion contained in this chapter is limited to the 1918 law, it must be remembered that the present law substantially re-enacts the 1918 law as to mutual insurance companies (other than life insurance companies). For that reason this discussion will be important in connection with such companies for the future as well as the past. It will also have a bearing upon the taxation of all insurance companies (other than life insurance companies) for the year 1921. In general, domestic insurance companies were subject, under the Revenue Act of 1918, to the same provisions as other domestic corporations, and foreign insurance companies were subject to the same provisions as other foreign corporations. In the case of insurance companies, both domestic and foreign, certain special provisions govern the calculation of gross income and the allowance of deductions.[34] These special provisions are the subject of this chapter.

DEFINITION. Insurance companies included both stock and mutual companies as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members was an insurance company, whether the fund for such purpose was created wholly by membership dues or partly by contributions from the employer. But a corporation which merely set aside a fund for the insurance of its employees was not required to file a separate return for such

[32] Cf. Revenue Act of 1921, § 234 (a) 13, Revenue Act of 1918, § 234 (a) 13. This deduction is discussed on p. 294 below.

[33] Cf. Revenue Act of 1921, § 233 (a), Revenue Act of 1918, § 233 (a) 2. See p. 294.

[34] Revenue Act of 1918, §§ 233 (a) 1 and 2, 234 (a) 10, 11, 12 and 13.

fund, if the income and disbursements therefrom were included in the corporation's own return.[35]

An organization doing business on the "interindemnity" or "reciprocal insurance" plan through an attorney-in-fact, subject to direction by an advisory board of policyholders, which require advance deposits to cover the cost of the insurance and maintained investments or deposits from which substantial income is derived, was held to be a mutual insurance company.[36]

GROSS INCOME OF INSURANCE COMPANIES. The gross income of insurance companies was determined in the same manner as in the case of other corporations except that (a) in the case of life insurance companies it did not include such portion of any annual premium received from any individual policyholder as was paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year[37] and (b) in the case of mutual marine insurance companies it included the gross premiums collected and received by such companies less amounts paid for reinsurance. The gross income of insurance companies consisted of their total revenue from the operation of the business and of their income from all other sources within the taxable year, except as otherwise provided by the statute. Gross income included net premiums (that is, gross premiums less returned premiums on policies cancelled and premiums on policies not taken), investment income,[38] profits from the sale of assets,

[35] Reg. 45, Art. 1508.

[36] L. O. 1063, T. B. 19-21-1626. This decision was made under the Capital Stock Tax imposed by § 1000 of the Revenue Act of 1918 and the tax imposed by § 503 of the Revenue Act of 1918. It seems equally applicable for purposes of the income tax. The cases chiefly relied upon by the solicitor were State v. Alley, 96 Miss. 720, 51 So. 467; and Imperial Fire Ins. Co. v. Coos Co., 151 U. S. 452, 462. The solicitor appears to have regarded these cases as superior in authority to Blanchard v. Hamblin, 162 Mo. App. 242, 144 S. W. 880. It was held that no individual legal title remained in the sums deposited under the arrangement indicated in the text. (See Young v. Teutonia Bank, 134 La. 879, 64 So. 806; Commercial Bank v. Armstrong, 148 U. S. 50; Sergeant v. Goldsmith Co., 110 Tex. 482; 159 S. W. 1036; 221 S. W. 259.) The amounts deposited were held to be premiums. Northwestern Life Assn. v. Stout, 32 Ill. App. 31, 38; Union Ins. Co. v. Hoge, 21 How. 35; U. S. Life Ins. Co. v. Spinks (Ky.), 96 S. W. 889. (See, however, Jewelers Safety Fund Society v. Lowe, 274 Fed. 93, note 38 below.) In holding that the association involved constituted a *mutual* insurance company, the solicitor relied upon Mutual Ins. Co. v. Herold, 198 Fed. 199, 209.

[37] This provision has no application after December 31, 1920. See p. 285.

[38] It was held, however, under the 1913 Law in the case of Jewelers Safety Fund Society v. Lowe, same v. Anderson, 274 Fed. 93 (reversing a lower court whose decision will be found in T. D. 3078, T. B. 44-20-1279)

and all gains, profits and income reported to the state insurance departments, except income specifically exempt from tax. Premiums received by mutual marine insurance companies paid out for reinsurance were required to be eliminated from gross income and the payments for reinsurance from disbursements. Deposit premiums on perpetual risks received and returned by fire insurance companies were required to be treated in the same manner, as no reserve was recognized covering liability for such deposits. The earnings on such deposits should be included in the investment income. A net decrease in reserve funds required by law within the taxable year should be included in the gross income.[39] But a decrease in reserve funds was only taxable if it resulted in the release to the general uses of the company of the reserves set up with the result that the company's "free assets" were increased. Although the reserves of an insurance company, other than a life insurance company, are generally speaking only a percentage of its surplus which may not be distributed in dividends, the effect is the same as if they were separate and distinct funds. The "unearned premium reserve" is not only a guarantee of payment of the policies against which it is held but also a fund to which resort may, in case of necessity, be made for payment of losses thereunder. If a loss occurs during the life of any policy the reserve established for the protection of such policy is released, and to that extent the reserve fund is reduced. If the reserve exceeds the amount of the loss and the policy is not continued in force, the excess becomes part of the general surplus

where the so-called premiums received by the company were simply deposited with it for convenience and could not be used by it or drawn upon until a loss was ascertained, that in such case the full amount of such deposits is not to be included in gross income, but only the sums actually taken by the society from these deposits for the purpose of paying operating expenses and losses. It was the practice of the society to deposit these premiums in a bank which paid interest thereon. The court held that this interest was not to be included in gross income because it belonged to the depositors and not the society. The society was incorporated in New York state by special act, without capital stock, for mutual protection of its members from loss by fire, burglary, etc., with power only to levy assessments after a loss occurred.

39 Revenue Act of 1918, § 233 (a) 1 and 2; Reg. 45, Art. 548; Reg. 33 Rev., Art. 239. A decrease in reserve funds is commonly called released reserve, and was to be treated as income for the year in which the reserve is released. (Reg. 33 Rev., Art. 240). Released reserves though not mentioned in express terms in the law have been held to be taxable income for the year in which released. (Maryland Casualty Co. v. U. S., 251 U. S. 342; T. D. 2451). Under the 1909 Law premiums were income of the year of the receipt (Lumber Mut. Fire Ins. Co. v. Malley, 256 Fed. 380).

of the company; it is "released to the general uses of the company." If, on the other hand, no loss is incurred by the policyholder, upon the expiration of the policy, the whole amount of the reserve held against it is released to the "general uses of the company" and increases its "free assets." In any case, therefore, in which there was a net decrease in the reserve funds of an insurance company it was necessary first to determine to what extent the reserves thus released had been applied in the payment of the losses against which they were held, and to what extent they exceeded the actual losses paid, and were, therefore, released to the "general uses of the company." So much of the released reserve as was applied to the payment of losses never became "free assets" of the company, and was not income of the company; but any excess which was released to general surplus thus becoming "free assets" available for any purposes of the company was income to the company in the year in which released.[40]

GROSS INCOME OF LIFE INSURANCE COMPANIES. A life insurance company was not required, under the 1918 Law, to include in gross income such portion of any actual premium received from any individual policyholder as was paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year.

"Paid back" meant paid in cash.

"Credited to" meant applied by the way of credit so as to reduce the premium received on the policy for the taxable year. It included dividends applied (a) directly to the payment of the premium for the taxable year; (b) to purchase additional paid-up insurance or annuities; or (c) to shorten the endowment or preium paying period; or (d) left with the company to accumulate at interest. It did not include the amount of divisible surplus annually ascertained and apportioned to deferred dividend policies.[41]

[40] L. O. 1032, T. B. 23-20-991; Maryland Casualty Co. v. U. S., 251 U. S. 342.

[41] Revenue Act of 1918, § 233 (a) 1; Reg. 45, Art. 549, as amended by T. D. 3153, T. B. 17-21-1600, in part reversing T. D. 3053, T. B. 34-20-1153 and Sol. Op. 40, T. B. 37-20-1195. T. D. 3153 was approved April 11, 1921. It was held under the 1916 Law that insofar as "deferred dividends" payable at a stated period represented "a portion of any actual premium received," they might be omitted from gross income for the year in which they were actually paid back, except that so much of any deferred dividends paid during the tax year to the individual policyholder as exceeded the amount of premiums paid during the same year might not be omitted; that only the actual amount of dividends actually credited or apportioned to a policy-

"Treated as an abatement of premium" meant of the premium for the taxable year.

Where the dividend paid back or credited to a policyholder was in excess of the premium received from such policyholder within the taxable year there might be excluded from gross income only the amount of the premium received, and where no premium was received from the policyholder within the taxable year the company was not entitled to exclude from its premiums received from other policyholders any amount on account of such dividend payment.[42]

It was proper for a life insurance company to exclude from gross income of the current year so much of the premiums paid during that year as did not exceed dividends applied by policyholders during the year to purchase additional paid-up insurance.[43]

The exact language of the Revenue Act of 1918 in regard to the gross income of life insurance companies was as follows: "In the case of life insurance companies there shall not be included in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year."[44] This language is substantially equivalent to the provision contained in the 1913 law with regard to the gross income of life insurance companies.[45] It has been held

holder during the premium-paying period, and not any accretions thereto, could be excluded from gross income. In the case of whole life or five-year distribution policies, deferred dividends could be excluded from gross income to the extent that they were paid back or credited to the insured or used as an abatement of annual premiums. (Reg. 33, Art. 100.)

[42] Revenue Act of 1918, § 233 (a) 1; Reg. 45, Art. 549, as amended by T. D. 3153, T. B. 17-21-1600, in part reversing T. D. 3053, T. B. 34-20-1153 and Sol. Op. 40, T. B. 37-20-1195. T. B. 3153 was approved April 11, 1921. Reg. 33 Rev., Art. 241. This provision has been dropped from the 1921 Law (See p. 275). Under the 1909 Law there was much litigation as to whether so-called dividends paid by insurance companies to policyholders as a return of a part of the premium were properly deductible. The courts held that the so-called dividends awarded annually to policyholders did not constitute income (Herold v. Mutual Benefit Insurance Co., 201 Fed. 918, affirming 198 Fed. 199) and at the time of the enactment of the 1913 and 1916 Laws the point was expressly covered by substantially the same language as in the present law.

[43] O. D. 994, T. B. 33-21-1770.

[44] Revenue Act of 1918, § 233 (a) 1.

[45] The provision of the 1913 Law was that life insurance companies—both stock and strictly mutual—"shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or

by the United States Supreme Court[46] that such provision of the 1913 law requires that purely mutual legal reserve companies issuing level-premium insurance shall include in gross income dividends paid by such companies to any policyholder and *not* applied in payment of a premium. The insurance company in this case contended that the non-inclusion clause of the 1913 law excluded from gross income the aggregate of all dividends paid to any policyholder by credit upon a premium or by abatement of a premium, and also all dividends whatsoever paid to any policyholder in cash, *whether applied in payment of a premium or not*. This contention was overruled by the Supreme Court for the following reasons:

1. Consulting the history of the Act of October 3, 1913, the Supreme Court found that the non-inclusion clause in question was framed to define what amounts involved in dividends should be "non-included" or deductible and thus prevent controversies over questions which had been raised by the Act of August 5, 1909.[47]

2. The contention was made by the insurance company that the nature of all life insurance dividends is the same, whatever the disposition made of them; that Congress could not have intended to relieve life insurance companies from taxation to the extent that dividends are applied in payment of premiums and to tax them to the extent that dividends are not so applied; that Congress must be assumed to have intended, in obedience to the demands of consistency, that all dividends should be treated alike. Disposing of this contention, the Supreme Court held that the differentiation between dividends applied in payment of a premium and those not so applied was entirely consistent, the principle being that of imposing taxation upon *net* premiums instead of *gross* premiums. The Supreme Court held that "there is a striking difference between an aggregate of individual premiums, each reduced by means of dividends, and an aggregate of full premiums from which it is sought to deduct amounts paid out by the company which have no relation whatever to premiums

treated as an abatement of premium of such individual policyholder, within such year." (Act of October 3, 1913, § II G (b).)

[46] Penn Mutual Life Insurance Co. v. Lederer, 252 U. S. 523; T. D. 3046, T. B. 33-20-1138. See Sol. Op. 70, T. B. 44-20-1280.

[47] See Mutual Benefit Life Insurance Co. v. Herold, 198 Fed. 199, in which the court stated that dividends applied as a reduction on renewal premiums "should not be confused with dividends declared in the case of a full-paid participating holder wherein the policyholder has no further premium payments to make. *Such payments having been duly made, the policy has become at once a contract of insurance and an investment.*"

received within the tax year, but which relate to some other premium which may have been received many years earlier." This second contention of the insurance company was also answered by the argument that the motive for taking level-premium life insurance may be mainly protection, but the motive of such insurance is largely that of "savings investment." When the dividend is applied in reduction of the renewal premium, Congress might well regard the element of protection as predominant, and treat the reduction of the premium paid by means of the dividend as merely a lessening of the expense of protection, but after the policy is paid up the element of investment predominates and Congress might reasonably regard dividends not applied in reduction of the renewal premium as profit on the investment.

3. The contention was made by the insurance company that the juxtaposition of the clauses covering the income of mutual fire and mutual life insurance companies and the provision covering mutual life insurance companies required the application of the same rule to all in regard to returned premiums. The Supreme Court answered this contention with the argument that the three different rules prescribed in three separate clauses for three classes of insurance was conclusive evidence that Congress deliberately intended to differentiate. The purpose of this differentiation was then explained by a consideration of the distinction between mutual fire and mutual marine insurance companies on the one hand, and mutual life insurance companies on the other. The thing for which a fire or marine insurance premium is paid is *protection,* which ceases at the end of the term. If after the end of the term part of the premium is returned, it is not returned as something purchased with the premium, but as a part of the premium which was not required to pay for the protection, that is, the expense was less than estimated. On the other hand, the service performed in level-premium life insurance is both protection *and investment.* Premiums paid have earned so much for the co-operators that the company is able to pay to each not only the agreed amount but also additional sums called dividends, which additional sums have been earned in part, at least, by transactions not among the members but with others, as by lending the money of the co-operators to third persons. The fact that the investment resulting in the accumulation or dividend is made by a co-operative, as distinguished from a capitalistic, concern does not prevent the amount thereof from being deemed a profit on the investment or from being taxable. The failure to differentiate between stock and

mutual life insurance companies was not inadvertent. There is a legal difference between stock fire and marine companies and mutual fire and marine companies, but the participating policy commonly issued by a stock life insurance company is both in rights conferred and in financial results substantially the same as a policy issued by a purely mutual life insurance company. The real difference between the two classes of life companies as now conducted lies in the legal right of electing the directors and officers.

4. Answering the contention of the company that the decision of the court below required the interpolation of the words "within such year" in the statute after the words "any individual policyholder," the Supreme Court held that what the insurance company was seeking was not to have "non-included" a part of the premiums which were actually received within the year or which appeared as a matter of bookkeeping to have been received, but actually were not, but that the company was seeking to have the aggregate of premiums actually received in a year reduced "by an amount which the company paid out within the year, mainly on account of premiums received long before the tax year"; that what the company really sought was "not a non-inclusion of amounts paid in—but the deduction of amounts paid out". The Supreme Court then referred to another provision of the statute prescribing that there might be deducted "the sums other than dividends paid within the year on policy and annuity contracts". This clause was held to be tantamount to a direction that dividends should not be deducted.

In support of the company's contention it was urged that the court should consider the history of the Revenue Act of 1918 and specifically that in that bill, as introduced and passed by the House, the corresponding section[48] contained the words "within the taxable year", and that these words were stricken out by the conference committee.[49] The court held that no aid could be derived from the legislative history of an act passed nearly six years after the one in question. It may be argued that this legislative history of the present statute indicates an intention on the part of Congress to permit dividends of a mutual life insurance company not applied in payment of premiums to be "non-included" in gross income. This contention would seem, however, to be unsound in view of the fact that the Revenue Act of 1918 contains a provision substantially the same as that con-

[48] Revenue Act of 1918, § 233 (a).

[49] Report No. 1037, 65th Congress.

tained in the 1913 law referred to by the Supreme Court; that is, it provides that insurance companies may deduct "the sums other than dividends paid within the taxable year on policy and annuity contracts".[50] This is apparently the view of the treasury department, and it has been held that a life insurance company is not entitled to exclude from its total income during the taxable year, for the purpose of ascertaining its gross income, any dividends paid or credited to policyholders from whom it did not receive any premium during that year; and as to policyholders from whom as it did receive premiums that year it is entitled to exclude only such part of the dividends paid to those policyholders as did not exceed the amounts received from them, respectively, by way of premiums during that year.[51]

DEDUCTIONS ALLOWED INSURANCE COMPANIES. Insurance companies were entitled, under the Revenue Act of 1918, to the same deductions from gross income as other corporations, and also to the deduction of the net addition required by law to be made within the taxable year to reserve funds and of the sums other than dividends paid within the taxable year on policy and annuity contracts.[52]

"Paid" included "accrued" or "incurred" (construed according to the method of accounting upon the basis of which the net income was computed during the taxable year), but did not include any estimate for losses incurred but not reported during the taxable year. As payments on policies there were required to be reported all death, disability and other policy claims (other than dividends as above specified) paid within the year, including fire, accident and liability losses, matured endowments, annuities, payments on installment policies and surrender values actually paid.[53]

[50] Revenue Act of 1918, § 234 (a) 10.

[51] T. D. 2899, T. B. 20-19-514. For the rule under the 1909 Law see Fink v. Northwestern Mutual Life Ins. Co., 267 Fed. 968; T. D. 3057, T. B. 36-20-1187.

[52] So-called cash bonuses and other sums paid as a gratuity by an insurance company to nonparticipating policyholders or beneficiaries have been held under the 1909 Law which permitted the deduction of "sums other than dividends paid within the year on policy and annuity contracts" (§ 38, Second) not to be deductible from gross income in corporation excise tax returns as sums other than dividends paid within the year on policy and annuity contracts. (Sol. Op. 100, T. B. 18-21-1612).

[53] Revenue Act of 1918, § 234 (a) 10; Reg. 45, Art. 568. Surrender values applied in any manner, consideration for supplementary contracts, involving and not involving life contingencies, should be included in the gross income of life insurance companies. Applied surrender values and consideration for supplementary contracts not involving life contingencies included in income

DEDUCTION OF REQUIRED ADDITION TO RESERVE FUNDS BY INSURANCE COMPANIES. Insurance companies were permitted under the 1918 law, to deduct from gross income the net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with state or territorial officers pursuant to law as additions to guarantee or reserve funds.[54] This was first considered to mean the net addition required by the specific statutes of the states within which the taxpayer transacted business. It was later held that a requirement by a state insurance commissioner that a net addition shall be made to certain amounts retained to meet specified liabilities was a net addition required by law to be made to reserve funds within the meaning of the statute, if required by rules and regulations promulgated in the exercise of an appropriate power conferred by statute.[55] Only reserves commonly recognized as reserve funds in insurance accounting were to be taken into consideration in computing the net addition to reserve funds required by law. Assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance and unpaid brokerage were not reserves the additions to which might be deducted.[56]

are deductible as payments under policy contracts, but for convenience in verifying the returns these items should appear in the return in gross income and deductions. (Reg. 33 Rev., Art. 241.)

[54] Reg. 45, Art. 569.

[55] Maryland Casualty Co. v. U. S., 251 U. S. 342, modifying 52 St. Cls. 201, T. D. 2451. In McCoach v. Insurance Co. of North America, 244 U. S. 585, 37 Sup. Ct. 709, it was held that a reserve required in Pennsylvania to be maintained by a fire and marine insurance company against unpaid losses was not a reserve required by law since it was not required by express statutory provision. There is nothing in this case inconsistent with the rule recently laid down in Maryland Casualty Co. v. U. S., 251 U. S. 342. There was no question in the McCoach case but that under an administrative interpretation of the Pennsylvania statute the reserve was required to be set up; the case turned upon the question whether the reserve was the kind of reserve referred to in the 1909 Law. In other words, the case involved a definition of the word "reserve". Under the 1909 Law it has been held that reserve funds, the net addition to which is to be deducted from the gross income of a life insurance company in computing its net income, are those funds which are built up to mature the policy, and do not include funds reserved because of liabilities on supplementary contracts not involving life contingencies and canceled policies upon which a cash-surrender value may be demanded. (Fink v. Northwestern Mutual Life Ins. Co., 267 Fed. 968; T. D. 3057, T. B. 36-20-1187.)

[56] Reg. 45, Art. 569; Maryland Casualty Co. v. U. S., 251 U. S. 342. A reserve for the expense of investigating loss claims of an insurance company

In the case of a casualty, liability, fidelity, guaranty and surety insurance company recently decided by the United States Supreme Court[57] the term "reserve" has been defined as follows: "* * * A sum of money, variously computed or estimated, which, with accretions from interest, is set aside, 'reserved', as a fund with which to mature or liquidate, either by payment or reinsurance with other companies future unaccrued and contingent claims, and claims accrued, but contingent and indefinite as to amount or time of payment." In the case of the company under consideration a "reserve for unearned premiums", a "special reserve for unpaid liability losses" and a "loss claims reserve" were held to fall within this definition. On the other hand, a reserve maintained by the insurance company for "unpaid taxes, salaries, brokerage and reinsurance due other companies" was held not to fall within such definition. The requirements of various states referring to such reserves use the term "reserve" in a nontechnical sense and not necessarily in the sense of the 1909 law. It has been held by the treasury department that the amount deductible as an addition to reserve funds is the excess of the total reserve fund as required by law at the end of the taxable year over the total of such reserve funds at the beginning of the year, regardless of the fact that during the year the reserve funds are increased on account of new business, and decreases in such funds are inevitable when policies mature, lapse, or are surrendered.[58]

In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned premium" fund. A reserve set up by a fire insurance company against unpaid losses has been held not to be deductible.[59]

Casualty companies might deduct losses incurred within the taxable year; but unless the net addition to the unpaid loss reserve required by law exceeded such losses incurred, no deduction for the net addition to the unpaid loss reserve might be taken. In any event only the excess of such net addition over such losses might be deducted.[60]

has been held not to be a "reserve" within the meaning of the 1913 Law and any net addition thereto may not be deducted in determining net income. (Sol. Op. 76, T. B. 47-20-1315.)

[57] Maryland Casualty Co. v. U. S., 251 U. S. 342. See the definitions of "reserve" in Fink v. Northwestern Mutual Life Ins. Co., 267 Fed. 968; T. D. 3057, T. B. 36-20-1187.

[58] O. D. 427, T. B. 13-20-876.

[59] L. O. 1056, T. B. 2-21-1391. This ruling applies under the 1916 Law, the 1913 Law, and the 1909 Law (O. D. 1094, T. B. 45-21-1912).

[60] Reg. 45, Art. 569.

In the case of life insurance companies the net addition to the "reinsurance reserve" and the "reserve for supplementary contracts[61] not involving life contingencies," and the net addition to any other reserve funds necessarily maintained for the purpose of liquidating policies at maturity, were legally deductible. An increase in the reserve maintained by a life insurance company to pay dividends on deferred dividend policies was not permitted to be deducted from gross income.[62]

A life insurance company which maintained a reserve to liquidate coupons left with the company to accumulate at interest and accrued interest thereon was held entitled to deduct from gross income the net addition made each year to such fund.[63] The reserves annually set aside by life insurance companies in the state of Nebraska for the protection of deferred dividend policies have been held to be reserves required by law in ascertaining whether there has been a net addition to reserve funds deductible in computing the net income.[64]

Mutual hail and mutual cyclone insurance companies were entitled to deduct from gross income the net addition which they were required to make to the "guaranty surplus" fund or similar fund.[65]

61 Where a life insurance company's policies contain an option to have proceeds paid in annual installments for a given term of years, or during the lifetime of the beneficiary, instead of in one sum, such policies, if the option is exercised, are styled "supplementary policy contracts." These obligations are protected by reserves, the net additions to which are deductible if such reserves are "required by law." The Commissioners of Insurance of all the states require the establishment of a reserve to cover the obligations of the company on such supplementary policy contracts. This fact of itself tends strongly to show that they are required by law (Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918).

62 Reg. 45, Art. 569.

63 O. D. 799, T. B. 1-19-96.

64 Sol. Op. 40, T. B. 37-20-1195.

65 Revenue Act of 1918, § 234 (a) 10; Reg. 45, Art. 569. Under the laws of Pennsylvania reserves against unpaid losses are required by law of casualty companies, but not of fire and marine insurance companies. Hence, the latter can not deduct reserves against losses, although the Insurance Commissioner of Pennsylvania may require such reserves under a practice of his office established for many years and relied upon as an administrative interpretation of the law of that state. (See Insurance Company of North America v. McCoach, 218 Fed. 905, reversed 224 Fed. 657, 661, writ of certiorari granted, 241 U. S. 694, reversed 244 U. S. 585; T. D. 2501.) It has been held that the act addition may be based upon the highest authorized reserve required by the statutes of any state in which the company does business, but that, having adopted the requirements of one state, a company can not base its reserve upon the requirements of another state for subsequent years (T. D. 1727; Reg. 33 Rev., Art. 240).

Special Deductions Allowed in the Case of Combined Life, Health and Accident Policies. Corporations issuing combination policies of life, health and accident insurance on the weekly premium payment plan, continuing for life and not subject to cancellation, were permitted, under the 1918 law, to deduct from gross income only such portion of the net addition not required by law made within the taxable year to reserve funds as was needed for the protection of the holders of such combination policies. In general, the net addition to any fund especially maintained for the protection of such policyholders might be deducted. The determination by the company of the need for such addition was subject to review by the commissioner, and the return of income was required to be accompanied by a full explanation of the basis upon which such fund and the additions to it were determined.[66]

Special Deductions Allowed Mutual Marine Insurance Companies. Mutual marine insurance companies should include in gross income the gross premiums collected and received by them less amounts paid for reinsurance. They may deduct from gross income amounts repaid to policyholders on account of premiums previously paid by them, together with the interest actually paid upon such amounts between the date of ascertainment and the date of payment thereof. The remainder of the premiums accordingly forms part of the net income of the company, except to the extent that they are subject to the deductions allowed insurance companies in general and other corporations.[67]

Special Deductions Allowed Mutual Insurance Companies. Mutual insurance companies (other than mutual life and mutual marine insurance companies), which require their members to make premium deposits to provide for losses and expenses, are allowed to deduct from gross income the aggregate amount of premium deposits returned to their policyholders or retained for the payment of losses, expenses and reinsurance reserves.[68] In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company

[66] Reg. 45, Art. 570; Sol. Op. 83, T. B. 3-21-1402. This provision is not applicable to life insurance companies after December 31, 1920, nor to any companies after December 31, 1921. See p. 281.

[67] Reg. 45, Art. 571; Revenue Act of 1918, §§ 233 (a) 2, 234 (a) 12. This provision is substantially the same in the Revenue Act of 1921.

[68] Revenue Act of 1918, § 234 (a) 13; Reg. 45, Art. 372. This provision is extended in the 1921 Law to interinsurers and reciprocal underwriters; otherwise it is substantially the same.

for the payment of losses, expenses and reinsurance reserves, it is to be presumed that losses and expenses have been paid out of earnings and profits, other than premiums, to the extent of such earnings and profits.[69] If, however, any portion of such amount is applied during the taxable year to the payment of losses, expenses or reinsurance reserves, for which a separate allowance is taken, then such portion is not deductible, and if any portion of such amount for which an allowance is taken is subsequently applied to the payment of expenses, losses or reinsurance reserves, then such payment can not be separately deducted. An amount of premium deposits retained for the payment of expenses and losses, and the amount of such expenses and losses, may not both be deducted. A company which invests part of the premium deposits so retained by it in interest-bearing securities may nevertheless deduct such part, but not the interest received on such securities. A mutual fire insurance company which has a guaranty capital is taxed like other mutual fire insurance companies. A stock fire insurance company, operated on the mutual plan to the extent of paying dividends to certain classes of policyholders, may make a return on the same basis as a mutual fire insurance company with respect to its business conducted on the mutual plan.[70]

Returns of Insurance Companies. Insurance companies transacting business in the United States or deriving income from sources therein are required to file returns of income. As an aid in auditing the returns it was suggested under the 1918 law that wherever possible a copy of the report to the state insurance department be submitted with the return. Otherwise it was suggested that a copy of Schedule D, parts 1, 3 and 4, of the report be attached to the return, showing the federal, state and

[69] L. O. 1050, T. B. 40-20-1226, overruling O. D. 403, T. B. 7-20-744.

[70] Revenue Act of 1918, § 234 (a) 13; Reg. 45, Art. 572. Under the 1916 Law it was provided that "mutual fire and mutual employers' liability and mutual workmen's compensation and mutual casualty insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus portions of their premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves." (Revenue Act of 1916, §12 (a).) It will thus be noted that in the case of such companies the amount of premium deposits returned to policyholders was excluded from gross income, under the 1916 Law, but under the present law the amount of such deposits will be included therein, and taken as a deduction; and this will also be true of such portions of their premium deposits as are retained for the payment of losses, expenses and reinsurance reserves.

municipal obligations from which the interest omitted from gross income was derived, and a copy of the complete report was required to be furnished as soon as ready for filing.[71]

Foreign Insurance Companies. Foreign insurance companies were required, under the 1918 law, to report as gross income only the gross income from sources within the United States. Income from business transacted by a United States branch or agency of a foreign insurance company which related to a foreign country was required to be returned as gross income.[72] Foreign insurance companies with agents or brokers in this country soliciting insurance and collecting premiums for them were held to be doing business in the United States, so that any income received from such sources was income from "sources within the United States".[73]

Expenses Under the 1916 Law. The same allowance for expenses was permitted to insurance companies as in the case of other corporations. Insurance companies were permitted to add to expenses, in lieu of depreciation of furniture and fixtures, the actual cost of repairs, replacements and renewals of such furniture, as reported to the state insurance department, provided that in the case of an original investment, the cost thereof was charged to capital account.[74]

[71] Reg. 45, Art. 623.
[72] Revenue Act of 1918, § 233 (b); Reg. 33 Rev., Art. 244.
[73] O. D. 586, T. B. 28-20-1062.
[74] Reg. 33 Rev., Art. 240.

CHAPTER 12

FOREIGN CORPORATIONS

Foreign corporations, like domestic corporations, are taxed as separate entities apart from their stockholders. They were subject, under the Revenue Act of 1918, to a tax of 10% upon their net income from "sources within the United States" for the years 1919 and 1920.[1] Under the present law, in lieu of that tax, they are subject to a tax of 10% upon their net income from "sources within the United States" for the year 1921, and 12½% for the year 1922 and subsequent years. This increase of rate is in lieu of the excess-profits tax which is repealed as of December 31, 1921. The most important changes made by the Revenue Act of 1921, bearing upon the taxation of foreign corporations relate to the definition of the term "sources within the United States." The definition of this term has been considerably amplified and in some respects modified, as is more fully indicated in a preceding chapter.[2] Another important new provision of the Revenue Act of 1921, treated in this chapter, is the provision that domestic corporations fulfilling certain qualifications shall be taxable only with respect to income from "sources within the United States."[3]

Definition. As used in this chapter, the term "foreign corporation" means a corporation, association, joint-stock company or insurance company created or organized outside the United States[4] including only the states, the territories of Alaska and

[1] Revenue Act of 1918, § 230. This rate was 12% for the year 1918.

[2] See Chapter 4.

[3] Revenue Act of 1921, § 262. See p. 308.

[4] See Revenue Act of 1921, § 2; Revenue Act of 1918, § 1; Reg. 45, Art. 1508. It is interesting to note in this connection the difference between the American and British theories of residence in regard to corporations. The definition given in the text and the definition of the term "domestic" when applied to corporations is founded upon the American conception that a corporation cannot migrate but must be and remain always a resident of the state or jurisdiction in which it is created. (See Paul v. Virginia, 8 Wall. 168.) This theory contemplates strictly the artificial entity of the corporation. The British statute provides: "For and in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere, and for and in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom from any profession, trade, employment, or vocation, whether the same shall be respectively carried on in the United Kingdom or else-

Hawaii, and the District of Columbia. Foreign corporations are in fact divisible into four classes, as follows: (1) "nonresident foreign corporations," which have no office or place of business in the United States; (2) "nonresident foreign corporations with a branch in the United States," which have their principal or head business office in a foreign country, but incidentally have branch offices or places of business in the United States; (3) "resident foreign corporations" which have their principal or head business office in the United States and do business solely in this country, and (4) "resident foreign corporations having branches outside the United States" which have their principal or head business office in the United States, but incidentally have branch offices or places of business outside the United

where, and to be charged for every twenty shillings of the annual amount of such profits and gains: And for and in respect of the annual profits or gains arising or accruing to any person whatever, whether a subject of her Majesty, or not, although not resident within the United Kingdom, from any property whatever in the United Kingdom, or any profession, trade, employment, or vocation exercised within the United Kingdom, and to be charged for every twenty shillings of the annual amount of such profits and gains." While the cases decided under this statute upon this point are in some confusion, coming to different conclusions upon substantially the same facts and the same conclusions upon different theories, and while in many of them the appellate court was constrained to its conclusions by cases stated unfavorably to the taxpayer and the rule that the judgment of the Commissioners on questions of fact could not be disturbed, the courts definitely renounce the place of incorporation, as a test of residence. In De Beers Consolidated Mines v. Howe (1906) App. Cas. 455, 95 L. T. 221; 22 T. L. R. 756, 5 Tax Cas. 198, Lord Loreburn, L. C., said: "In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad." Again in San Paulo Ry. Co. v. Carter (1896) App. Cas. 31, 73 L. T. 538; Lord Halsbury said: "It seems to me that, as was said by Cockburn, C. J. in the case of Sulley v. Attorney-General (1), 'it is probably a question of fact where the trade is carried on,' and it is probably true to say that that phrase may be understood in two different senses. It may mean where the goods in respect of which trading is carried on are conveyed, made, bought, or sold; or, speaking of land, where it is cultivated or used for any other purpose of profit. That makes the locality of the goods or the land which are the subjects of the trade to be in a certain sense the place where the trade is carried on, because it is the place where the things corporeally exist, or are dealt with. But there is another sense, in which the conduct

and management, the head and brain of the trading adventure, are situated in a place different from that in which the corporeal subjects of trading are to be found. It becomes, therefore, a question of fact, and according to the answer to be given to the question where is the trade in a strict sense carried on, will the assessment be." (See also New Zealand Co. v. Stephens, 24 T. L. R. 172; American Thread Co. v. Joyce, 104 L. T. R. 217, affirmed 106 L. T. R. 171, 28 T. L. R. 233, 6 Tax Cas. 1; approved by House of Lords, 108 L. T. R. 353, 6 Tax Cas. 163, 29 L. T. R. 266.) In addition, the British courts have taxed many foreign corporations on the theory that they were a mere sham, fiction, or dummy, having no real existence apart from some English corporation which owned and controlled them, and also on the theory that they stood in the relationship of principal and agent toward an English company, so that their profits were in contemplation of law the profits of the principal. (See Colquhoun v. Brooks, L. R. 14 App. Cas. 493, 61 L. T. 518; Frank Jones Brewing Co. v. Apthorpe, 15 T. L. R. 113, 4 Tax Cas. 6; United States Brewing Co. v. Apthorpe, 4 Tax Cas. 17; St. Louis Breweries v. Apthorpe, 79 L. T. R. 551, 15 T. L. R. 112; 4 Tax Cas. 111; Apthorpe v. Peter Schoenhofen Brewing Co., 80 L. T. R. 395, 15 T. L. R. 245, 4 Tax Cas. 41.) It has not been held invariably under the British statute that foreign corporations were taxable when their stock was owned by British corporations. (Bartholomay Brewing Co. v. Wyatt (1893) 2 Q. B. 499, 69 L. T. 561; Kodak Ltd. v. Clark (1902) 2 K. B. 450, affirmed (1903) 1 K. B. 505, 88 L. T. R. 155; Gramophone & Typewriter, Ltd. v. Stanley (1906) 2 K. B. 856, affirmed (1908) 2 K. B. 89, 99 L. T. R. 39). In the last mentioned case the court said: "The fact that an individual by himself or by his nominee holds practically all the shares in a company may give him the control of the company in the sense that it may enable him by exercising his voting powers to turn out the directors and to enforce his own views as to policy, but it does not in any way diminish the rights or powers of the directors, or make the property or assets of the company his as distinct from the corporation's. Nor does it make any difference if he acquires not practically the whole, but absolutely the whole of the shares. The business of the company does not thereby become his business. He is still entitled to receive dividends on his shares, but no more * * *. The profits of a corporation are not profits of any business carried on by him in a foreign country, because the individual corporator does not carry on the business of the corporation. He is only entitled to the profits of that business to a certain extent freed and ascertained in a certain way depending on the constitution of the corporation and his holding in it. This legal proposition that the legal corporator cannot be held to be wholly or partly carrying on the business of the corporation is not weakened by the fact that the extent of his interest in it entitles him to exercise a greater or less control over the manner in which that business is carried on. Such control is inseparable from his position as a corporator and is a wholly different thing both in fact and in law from carrying on the business himself. The directors and employees are not his agents, and he has no power of giving directions to them which they must obey. This shows that the control of individual corporators is something wholly different from the management of the business itself. * * * In order to succeed the Attorney-General must, I think, make out either first, that the German company is a fiction, a sham, a simulacrum, and that in reality the English company and not the German company is carrying on the business; or secondly, that the German company, if it is a real thing, is

States.[5] In this chapter, however, a foreign corporation engaged in trade or business within the United States or having an office or place of business therein will be referred to as a "*resident* foreign corporation" and a foreign corporation not having any office or place of business therein will be referred to as a "nonresident foreign corporation."[6] The Revenue Act of 1921 contains a new provision substantially classifying certain domestic corporations as foreign corporations, which provision is discussed below.[7]

Corporations Exempt from the Tax. The corporations enumerated in the law as exempt include foreign corporations as well as domestic corporations, except as stated in the chapter on exempt organizations.[8]

Corporations Subject to the Tax. All foreign corporations receiving income from sources within this country and not specifically exempt are subject to the tax. It is not necessary that foreign corporations should be engaged in business in this country or that they have an office, branch or agency in the United States. Liability to the income tax attaches with respect to any income, the "source" of which is in the United States.[9]

the agent of the English company. In Kodak Limited v. Clark (ubi sup.) by way of contrast the English company owned 98 per cent. of the shares. It is true that they did not own them all, but that was not the ground of the decision. The ground was that, while the English company as holding 98 per cent. of the shares no doubt had the control, they had it only as shareholders, and it was the corporation and not the shareholders who were carrying on the business." The 1918 ruling of the treasury department that dividends on stock and interest on notes of corporations organized in the United States (viz., "domestic" corporations, Revenue Act of 1918, § 1) but doing no business and owning no property therein paid to nonresident alien individuals and corporations are not subject to tax (Reg. 45, Art. 92) is more consistent with the British than the American theory. The doctrine of corporate entity, as applied by the American courts, is discussed in Chapter 10.

[5] See T. D. 2401; Reg. 33 Rev., Art. 200.

[6] See Reg. 45, Art. 1508. See O. D. 517, T. B. 21-20-955.

[7] See p. 308.

[8] Revenue Act of 1921, § 231; Revenue Act of 1918, § 231. See Chapter 13.

[9] Reg. 33 Rev., Art. 66. See p. 301 on which the word "source" is discussed and where it is shown that the receipt of income from "sources within the United States," rather than the doing of business within the United States, is the test as to the taxability of foreign corporations; in other words, that the Revenue Act of 1921 and the Revenue Act of 1918 as to *foreign* as well as domestic corporations impose an *income*, not an excise tax. The act of August 5, 1909, was an excise tax law, both with respect to domestic and foreign corporations, measured with reference to net income.

Income Subject to Tax. The gross income of a foreign corporation includes only the gross income from "sources within the United States."[10] From the amount of such gross income may be subtracted the sum of the deductions and credits enumerated in the law, with the exceptions and subject to the limitations indicated in a preceding chapter.[11]

Rate of Tax. The rate of tax imposed upon foreign corporations by the present law is the same as that imposed upon domestic corporations—10% for the calendar year 1921, and 12½% for the calendar year 1922, and subsequent years.[12]

Income from Sources Within the United States. While the United States has power to tax a foreign corporation for the privilege of doing business in the United States,[13] the Revenue Act of 1921 and the 1918 law both levy a tax not upon such privilege, but upon income "from sources within the United States."[14] The subject of what constitutes income from such sources is thoroughly discussed in another chapter, as that term is to be defined in the case of nonresident alien individuals and foreign corporations.[15] It is sufficient to note at this point that the term "sources within the United States" is more definitely defined in the Revenue Act of 1921 than in the Revenue Act of 1918, or any preceding income tax law.[16] A few rulings and regulations, having special application to foreign corporations, rather than nonresident alien individuals, are discussed in the following paragraphs, as well as an important exemption provision which applies in the case of a certain class of foreign corporation—foreign steamship companies.

DOMESTIC CORPORATION OWNING STOCK OF FOREIGN CORPORATION. A foreign corporation, 99% of whose stock was owned by a domestic corporation, the balance being held by foreign officers as qualifying shares, entered, in 1918, into certain agreements with the domestic corporation under which the latter agreed to give the former the benefit of its experience and special knowledge and the use of equipment for the manufacture of the particular products, to loan to the former plans,

(Flint v. Stone-Tracy Co., 220 U. S. 107; Bryant & May, Ltd. v. Scott, 226 Fed. 875.)

10 Revenue Act of 1921, § 233 (b); Revenue Act of 1918, § 233 (b).

11 See Chapter 4.

12 Revenue Act of 1921, § 230.

13 See Footnote 9.

14 Revenue Act of 1921, §§ 230 (a), 233 (b); Revenue Act of 1918, §§ 230 (a), 233 (b).

15 See Chapter 4.

16 See Revenue Act of 1921, § 217.

specifications, drawings, patterns, etc., and to furnish the services of experienced engineers, draughtsmen and experts, in consideration of which assistance the domestic corporation was to receive a fixed percentage of the net profits of the foreign corporation. It was held that the ownership by the American corporation of stock in the foreign corporation and the contractual relationship between the two corporations had no bearing on the determination of whether the income of the foreign corporation from the sale of its products to the United States government was income from "sources within the United States." The two corporations were separate and distinct taxable entities. They were not required under the 1918 law and would not be permitted, to file a consolidated return and the contractual relationship did not constitute the American corporation the agent of the foreign company. The American corporation merely received compensation for assistance rendered and dividends on its stock holdings. The foreign corporation maintained no office or place of business in the United States during the period in question and the sole question was held to be where the goods contracted for were purchased and sold. As it appeared that the foreign corporation executed the contract for sale outside the United States, manufactured and made delivery of the goods to the United States government, f. o. b. at a point outside the United States, and received payment therefor outside the United States, it was held that the profits from such sales were not derived from "sources within the United States."[17]

Foreign Corporations Having No Office or Agent in This Country, Collecting Commissions. It was ruled under the 1916 law that a foreign corporation located at Singapore, having no office or agent in the United States, which was engaged in the commission business, and which during the year 1917 sold at Singapore and in nearby countries certain products of manufacturing establishments in the United States—the purchase price of the goods being transmitted by the purchasers to the manufacturers and American houses direct, and when the money was received in the United States a commission being paid out of the proceeds of sale to the Singapore corporation—was not in receipt of income derived from sources within the United States; also that should an American corporation receive these commissions from the manufacturer and transmit them to the Singapore corporation, where it simply acted as agent for the Singapore corporation in receiving and transmitting such com-

[17] A. R. M. 133, T. B. 26-21-1703.

missions and retained no part thereof for its own use, it need not report them as its own income.[18] Amounts paid to a nonresident foreign corporation as compensation for orders secured by it from foreign customers for exports booked through such nonresident foreign corporation are held not to be income from sources within the United States.[19]

FOREIGN STEAMSHIP COMPANIES. The present law specifically exempts the income of a nonresident alien or foreign corporation, consisting exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country, which grants an equivalent exemption to citizens of the United States and domestic corporations.[20] This is a new exemption created by the Revenue Act of 1921, designed to "encourage the international adoption of uniform tax laws affecting shipping companies, for the purpose of eliminating double taxation."[21] Under the 1918 law the tax did not apply to charter money or freight payments received by a foreign owner in regard to a vessel operated between the United States and foreign ports, if the person receiving the income maintained no regular agency in the United States and was not doing business in the United States.[22] Foreign steamship companies engaged in the business of transporting passengers, goods and merchandise between ports in this country and foreign ports and maintaining passenger and freight agencies in this country, were subject to the income tax imposed by the 1918 and previous laws and will be subject to the tax imposed by the present law if the laws of the country under which their ships are documented do not grant the "equivalent exemption" referred to above. There seems to be no constitutional objection involved in such tax being a tax on exports.[23] Foreign steamship companies were

18 Letter from treasury department dated April 20, 1918; I. T. S. 1921 ¶ 1087.

19 O. D. 112, T. B. 2-19-167.

20 Revenue Act of 1921, § 213 (b) 8.

21 See Report of Finance Committee on Revenue Bill of 1921, p. 14.

22 Reg. 45, Art. 92.

23 28 Op. Atty. Gen. 211; Aguirre v. Maxwell, 3 Blatch. 140; Peck v. Lowe, 247 U. S. 165. For the method of computing the income of such companies from sources within the United States see letter from treasury department dated July 18, 1916; I. T. S. 1921, ¶ 1082. But this is a highly unsatisfactory method and its legality is extremely doubtful. In effect, it holds that receipts from *outgoing* freight and passenger traffic is income from sources within the United States. It would seem that the going and coming voyage of a steamship should be treated as a unit, and not more than 50% at most of the ship's gross receipts treated as coming from United States sources. In general the factors producing the income are (1)

held not to derive income from "sources within the United States" by reason of the fact that they received, at a port within the United States, freight originating in a foreign country to be shipped to another foreign country. Income from "sources within the United States" was held to be that derived from freight charges paid to the companies within the United States in respect of shipments *originating* therein.[24] When freight shipments, originating in Canada, were brought to a United States port by railroad and received at that port by a foreign steamship company (which did business and maintained a regular agency in the United States) for transportation abroad, and the freight charges of the steamship company were prepaid by the railroad company, and the company's vessels, upon their return voyage to the United States, used coal purchased abroad as ballast, which was sold upon arrival in the United States, the freight charges on the goods transported abroad were held, under the 1918 law, to represent income from "sources in the United States." The amount received for the ballast coal disposed of in the United States was held to be gross income from sources within the United States, and the cost of such coal a deduction.[25]

Deductions in Computing Net Income from Sources Within the United States. The deductions of a foreign corporation, like those of a nonresident alien individual, are in general the same as those allowed to domestic corporations, except that such deductions will be allowed "only if and to the extent that they are connected with income from sources within the United States"; and the proper apportionment and allocation of such deductions with respect to income from sources within and sources without the United States is to be determined as outlined in another chapter.[26]

Items Not Deductible. No deduction will be allowed to foreign corporations in respect of certain items which are expressly specified by the statute not to be deductible. These items are the

the loading (or discharging) in this country, (2) the navigation, and (3) the discharging (or loading) in a foreign country. It is difficult to measure the navigation factor which occurs chiefly without the jurisdiction of this country, but the other two factors are certainly equally important, and neglecting navigation entirely as a factor, there would seem to be no greater gross income from sources within the United States than 50% of the gross receipts on both sides of the ocean. In the case of trades other than trans-Atlantic trades, the problem is even more complicated.

[24] O. D. 1024, T. B. 36-21-1806.

[25] O. D. 596, T. B. 29-20-1077.

[26] See Revenue Act of 1921, §§ 234 (b), 217. See Chapter 4.

same in the case of individuals, resident or nonresident, and corporations, domestic or foreign, and are enumerated and discussed in another chapter.[27]

Credits Allowed to Foreign Corporations. In addition to the above mentioned deductions foreign corporations are allowed the same credits as are allowed to domestic corporations, except the specific exemption which is allowed only to domestic corporations. These credits are more fully discussed in another chapter.[28]

Collection of the Tax at the Source. The withholding provisions of the Revenue Act of 1921 applying to foreign corporations are similar to the corresponding provisions of the 1918 law, except that withholding is no longer required on interest on deposits with persons carrying on the banking business paid to nonresident foreign corporations. In the case of nonresident foreign corporations, a tax equal to 10% in 1921, and 12½% in 1922 and subsequent years, is withheld at the source on payment of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits and income, except that the law requires a tax equal only to 2% to be withheld at the source on all interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation containing a so-called "tax-free covenant."[29] A nonresident foreign corporation cannot, by filing any certificate or claim for exemption, prevent the withholding of such tax, but if there is included in such corporation's return of all income received from sources within the United States, any income upon which tax has been withheld at the source, the corporation may take credit against the amount of tax due for the amount of the tax so withheld at the source, provided a statement is attached to the return setting forth the source and the amount of the income upon which the tax was so withheld. If a return discloses the

27 See Revenue Act of 1921, §§ 235, 214; Revenue Act of 1918, §§ 235, 215.

28 Revenue Act of 1921, § 236; Revenue Act of 1918, § 236. See Chapter 31.

29 Revenue Act of 1921, §§ 221, 237; Revenue Act of 1918, §§ 221, 237. The tax on corporation bonds containing "tax-free covenants" is required by law to be withheld only at the rate of 2% in order to limit the obligation of debtor corporations under those covenants. It seems, therefore, on such bonds the remainder of the income may be paid over without withholding by the debtor corporation. The collection of the remaining tax on the interest paid has no doubt been considered by the treasury department, but it is difficult to find a method by which this can be done without increasing the liability of the debtor corporations under their covenants, which liability the law expressly limits.

fact that the tax withheld exceeds the liability of the corporation, the treasury department then orders a refund of the excess amount withheld. For this purpose the return of the foreign corporation should have attached thereto a statement giving the names of the withholding agents and the amounts withheld respectively.[30] There is no collection of the tax at the source on payments of any kind to resident foreign corporations.[31]

Procedure in Collecting Income Subject to Withholding. To enable debtors in the United States to distinguish between resident and nonresident foreign corporations (foreign corporations which have, and those which have not any office or place of business in the United States) and also to enable resident foreign corporations to claim exemption from withholding on bond interest or other income, a certificate stating that any such corporation has an office or place of business in the United States should be filed by it with the debtor.[32]

Resident Agents for Foreign Corporations. In addition to the provisions prescribed by law for the collection of the tax at the source on income paid to nonresident foreign corporations the treasury department has evolved a method of collecting the tax by impressing upon residents of this country under certain circumstances the duty of filing returns and accounting for any taxes which may be due from nonresident foreign corporations on the income which passes through the hands of such residents. This duty is discussed fully in another chapter.[33]

Returns of Foreign Corporations. Every foreign corporation receiving income from sources within this country is required to make a return of income, stating specifically the items of its gross income and the deductions and credits to which it may be entitled.[34] It is not necessary, however, in order to be required to make a return, that a foreign corporation shall be engaged in business in this country or that it have any office, branch or agency in the United States.[35]

When Filed. The return of a nonresident foreign corporation is filed on or before June 15th, or the 15th day of the 6th

[30] Revenue Act of 1921, §§ 221 (d), 237; Revenue Act of 1918, § 221 (d); Reg. 45, Art. 376; Reg. 33 Rev., Art. 201. (See also Reg. 33 Rev., Art. 43; Reg. 33, Art. 46, and Chapter 40.)

[31] Revenue Act of 1921, § 237; Reg. 45, Art. 361.

[32] Reg. 45, Art. 601.

[33] Reg. 45, Art. 404. See Revenue Act of 1916, § 9 (g) and Chapter 5

[34] Revenue Act of 1918, § 239; Reg. 45, Art. 625.

[35] Reg. 45, Art. 625.

month following the close of the fiscal year of the corporation, accordingly as the corporation reports on the basis of the calendar or a fiscal year. The return of a resident foreign corporation is filed on or before March 15th, or the 15th day of the 3rd month following the close of the fiscal year of the corporation.[36]

WHERE FILED. The return of a foreign corporation should be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.[37]

BY WHOM FILED. The responsibility for filing the return of a foreign corporation rests in some cases on the agent of the foreign corporation in the United States, as indicated in another chapter.[38] When the return is filed by the officers of the foreign corporation, the agent of the corporation in this country is relieved of the responsibility.

HOW PREPARED. The return of a foreign corporation is prepared in the same manner as the return of a domestic corporation, except that the statements contained therein should relate to income from "sources" within this country and the deductions should be limited as above indicated.[39]

HOW SIGNED AND SWORN TO. If the return of a foreign corporation is filed by the home office, it should be sworn to by the president, vice president or other principal officer of the corporation and by the treasurer or assistant treasurer, and be verified in the same manner as is required in the case of domestic corporations.[40] In case the return is signed by the agent for the corporation resident in this country, the affidavit on the form should be changed to show that report is made by such agent, and covers all the income coming into his hands, or all the income of the corporation from "sources within the United States," as the case may be.

[36] Revenue Act of 1921, §§ 241 (a), 227 (a). Under the 1918 Law, such corporations filed returns at the same time as other corporations. See Chapter 34.

[37] Revenue Act of 1921, § 241 (b); Revenue Act of 1918, § 241 (b); Reg. 45, Art. 651.

[38] Reg. 45, Art. 625. See Chapter 5. A foreign corporation having several branch offices in the United States was required, under the 1916 Law, to designate one of such branches as the principal office and to designate the proper officer to make the required return. (Reg. 33, Art. 83.)

[39] See p. 304.

[40] Revenue Act of 1921, § 239; Revenue Act of 1918, § 239.

Consolidated Returns. The Revenue Act of 1921 modifies the former provision for the filing of consolidated returns by affiliated corporations, but this provision does not apply to foreign corporations, except that the Commissioner may, as indicated in another chapter, consolidate the accounts of related trades or businesses, including foreign trades or businesses, whether incorporated or not.[41]

Special Returns. Resident foreign corporations are required to make the same special returns for the purpose of information at the source as are required of domestic corporations.[42] Nonresident alien corporations are not required to make special returns by any express provision of the law, but may be called upon under general provisions of the law for information respecting their income from sources in this country.

Duty of Foreign Corporations in Paying Out Income. In paying out income to others subject to the tax, a resident foreign corporation is subject to all the duties and responsibilities imposed upon domestic corporations as to withholding the tax at the source or reporting the names of the persons to whom such income is paid.[43] Nonresident foreign corporations are under no duty in paying out income to others, whether or not such payees are citizens or residents of this country.

Collection of Foreign Items. Resident foreign corporations undertaking as a matter of business or for profit the collection of foreign items are required to obtain a license in the same manner as domestic corporations.[44]

Penalties. Foreign corporations, or their officers or employees, are subject in certain cases to penalties, both specific and *ad valorem,* for failing or refusing to make returns, supply information, pay or collect any tax or for wilfully attempting in any manner to defeat or evade the tax. Such penalties are more particularly discussed in another chapter.[45]

Domestic Corporations Which Are Taxable Only on Income From Sources Within the United States. Domestic corporations which satisfy the two conditions stated below are taxable only with respect to income from "sources within the United States." This constitutes an exception to the general rule which has been invariably applied hitherto in taxing domestic corporations that

41 See Chapter 10.

42 Revenue Acts of 1918 and 1921, §§ 254, 255 and 256.

43 Revenue Acts of 1918 and 1921, §§ 221, 237 and 256. For a further discussion of this subject see Chapters 40 and 39.

44 Revenue Acts of 1918 and 1921, § 259. See Chapter 10.

45 See Chapter 36.

they are residents of this country if organized under the laws of any state, or political subdivision of the United States and as such residents are taxable upon their income from all sources, even though their business may be done or their property located entirely abroad. The conditions referred to are:

(1) 80% or more of the gross income of such domestic corporation (computed without the benefit of this provision) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) must have been derived from sources within a possession of the United States; and (2) 50% or more of its gross income (computed without the benefit of this provision) for such period or such part thereof must have been derived from the active conduct of a trade or business within a possession of the United States. Notwithstanding the rule stated above there must be included in the gross income of such domestic corporations all amounts received within the United States, whether derived from sources within or without the United States.[46]

Foreign Governments. Any income received by foreign governments from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest or deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States, is exempt from the income tax. The regulations and rulings issued under the 1918 law, which contained precisely the same exemption, should control under the present law. But this exemption does not apply to income from investments in the United States in stocks, bonds, or other domestic securities which are not actually owned, but are loaned to such foreign governments.[47] Income derived by a foreign corporation from sources within the United States is subject to federal tax, regardless of the fact that 51% of its

[46] Revenue Act of 1921, § 262. It was first intended to make this section retroactive, but this intention was abandoned. It now operates as of January 1, 1921.

[47] Revenue Act of 1921, § 213 (b) 5; Revenue Act of 1918, § 213 (b) 5; Reg. 45, Art. 83; O. D. 710, T. B. 24-20-1275. Under the 1916 Law, prior to the amendment of October 3, 1917, it was held by the treasury department that the income accruing to a foreign government from sources within the United States arising from interest on bonds or dividends on stock of domestic corporations was subject to tax. The 1917 Law provided that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by them, or from interest on deposits in banks in the United States of money belonging

stock is owned by a foreign government.[48] Interest credited by a domestic bank to the account of a foreign bank, part of whose stock is owned by a foreign government, is not exempt from income tax.[49] A foreign government is not subject to tax on income derived from the operation of vessels owned by such government through its agents in the United States. Neither is the foreign government liable to tax upon the income arising from the operation for its benefit of vessels chartered by it.[50]

POLITICAL SUBDIVISIONS OF FOREIGN GOVERNMENTS. The exemption discussed in the previous paragraph applies to the political subdivisions of foreign governments.[51] The Commonwealth Bank of Australia was established by an act of the legislature of Australia, which provided that the appointment of the governor of the bank and the control of its affairs should be vested in officials of the government; that the capital necessary for its operations should be supplied solely by the sale of interest-bearing obligations, not entitling the purchaser thereof to any interest in the bank or to any share in its profits, the issuance and sale of which are to be controlled by the governor-general of the commonwealth; that the securities so issued are guaranteed by the commonwealth; that the commonwealth is exclusively entitled to any profits of the bank and is the guarantor of its debts. The bank is, therefore, a governmental agency of the commonwealth of Australia and as such is exempt from income tax.[52]

FOREIGN AMBASSADORS AND MINISTERS. The income of foreign ambassadors and ministers from investments in bonds and stocks and from interest on bank balances, and the fees of for-

to such foreign governments was exempt. This did not, however, exempt from the tax any income collected by foreign governments from investments in the United States in stocks, bonds or other domestic securities, which were not *bona fide* owned by but were loaned to such foreign governments. The exemption was and still is predicated upon the fact that the securities or moneys from which income was derived were actually owned by such foreign governments. (Reg. 33 Rev., Art. 87; T. D. 2425; Revenue Act of 1916, as amended by Revenue Act of 1917, § 30; O. D. 483, T. B. 18-20-895; O. D. 20, T. B. 1-19-32.)

48 O. D. 958, T. B. 26-21-1702.

49 O. D. 448, T. B. 15-20-844. Such interest is not income from "Sources within the United States" under the present law, if paid to a nonresident foreign corporation not engaged in business in the United States (Revenue Act of 1921, § 217 (a) 1).

50 O. D. 515, T. B. 21-20-951.

51 Reg. 45, Art. 83.

52 O. D. 628, T. B. 33-20-1129.

eign consuls, are exempt from tax, but income of such foreign officials from any business carried on by them in the United States would be taxable.[53] Only foreign diplomats, ambassadors, and other diplomatic representatives in charge who are accredited to the United States to represent their sovereign or country and who reside in the United States, and the members of their staff, are entitled to this exemption. Foreign consuls resident in the United States are not entitled to the exemption, except as to fees.[54] Delegates to the United States representing a foreign country in connection with an agreement with the United States food administration, whereby flour is furnished to that country, and raw materials are brought to this country and sold, are not subject to tax with respect to any profits derived from the sale of such products.[55] The compensation of citizens of the United States who are officers or employees of a foreign government is not exempt from tax.[56] A subject of a foreign country, who at the time of his appointment to a legation in the United States is a resident of the United States, would be subject to tax on the same basis as a citizen of the United States.[57] The provision which exempts income of foreign ambassadors, ministers, and their subordinates who were nonresident aliens at the time of appointment extends to income received by their wives from sources within the United States.[58]

[53] Reg. 45, Art. 83.
[54] O. D. 336, T. B. 29-19-624.
[55] O. D. 182, T. B. 8-19-315.
[56] Reg. 45, Art. 83.
[57] O. D. 196, T. B. 9-19-339.
[58] O. D. 1115, T. B. 48-21-1945, overruling O. D. 153, T. B. 5-19-248.

CHAPTER 13

EXEMPT ORGANIZATIONS

The Revenue Act of 1918, with the exceptions noted below, exempted the same classes of corporations as the 1916 Law. The Revenue Act of 1921 continues the exemption to the same classes of corporations, in certain cases limiting or describing such corporations in somewhat greater detail than the 1918 Law. These additional limitations will be discussed in the paragraphs in this chapter dealing with the classes of corporations affected. There are fourteen classes of exempt organizations.[1] Exempt corporations are required to withhold the tax at the source, and to report payments of income to others, in the same manner as is required of taxable corporations.[2]

Foreign Corporations. The exemptions of the law apply to foreign corporations as well as to domestic corporations, except in the case of building and loan associations and co-operative banks.[3] In case a foreign corporation desires to be held exempt from the law and doubt exists as to whether or not it comes within the classes of organizations enumerated in the law, it is required to file a copy of its charter or articles of incorporation and by-laws and an affidavit executed by its principal officer showing the sources of its income and its disposition, whether or not any of its income is credited to surplus or may inure to the benefit of any private stockholder, or individual, and in general all facts relating to its operations which relate to its

[1] Revenue Act of 1921, § 231; Revenue Act of 1918, § 231. The first eight of these classes were exempt under the 1913 Law; the next five classes were added by the 1916 Law. The 1918 Law and the 1921 Law discontinue the exemption granted by the 1916 Law to joint-stock land banks and add an exemption in favor of personal service corporations. Corporations exempt under the 1916 Law were also exempt to the same extent under the 1917 Law. (Reg. 33 Rev., Art. 68.)

[2] T. D. 2693; T. D. 2407; Reg. 33 Rev., Art. 81. Exempt corporations under the 1913 Law were exempt from all provisions of the law, and it was held that this included exemption from the duty of acting as withholding agent, but under the 1916 Law and the present law the rule is as stated in the text. The 1913 Law provided that "nothing in this section" should apply to the corporations enumerated as exempt; the 1916 Law: "there shall not be taxed under this title any income received by" such exempt corporations; the 1918 and the 1921 Laws: "the following organizations shall be exempt from taxation under this title."

[3] The provisions of §11 of the 1916 Law were so held. (Letter from treasury department dated December 6, 1916; I. T. S. 1921, ¶ 1073.)

rights to exemption. The question whether or not the organization will be held exempt is determined by the treasury department upon the facts so shown.[4]

Exemption Limited to Classes Specifically Enumerated. Any corporation, no matter how created or organized, or what the purpose of its organization may be, is taxable unless it comes within the classes of organizations specifically enumerated as exempt. A corporation is not exempt simply and only because it is primarily not organized and operated for profit. If income within the meaning of the law arises and accrues to a corporation, such income will be subject to the tax unless the corporation is one of the exempt organizations expressly enumerated in the law. Thus, commercial men's associations, and like organizations are not exempt, as they are not expressly enumerated, although they may be corporations not organized for profit.[5] Where a corporation is organized for the purpose of owning and operating an apartment house, its income being derived from co-operatively collecting the expense of operating the apartments each month from its members, each of whom is entitled to occupy an apartment in the building, it has been held that inasmuch as there is no provision in the law expressly exempting co-operative home-owning corporations from taxation such a corporation is precluded from exemption.[6] An organization which would otherwise be exempt, but which operates in a nonexempt manner is not entitled to exemption; and an organization which is ordinarily exempt, but which owns property in excess of its needs and carries on industrial pursuits distinct from its exempt activities is not exempt.[7]

Where Question as to Right of Exemption Exists. In order to establish exemption, and thus be relieved from the duty of filing returns of income and paying the tax, it is necessary that every organization claiming exemption, except personal service corporations, file an affidavit with the collector of the district in which it is located, showing (1) the character and purpose of the organization; (2) the source from which all its income is derived; (3) what disposition is made of such income; and (4) whether

[4] Reg. 45, Art. 511; Letter from treasury department dated December 5, 1916; I. T. S. 1919, ¶ 2284.

[5] T. D. 2152. See Commercial Travelers etc. Ass'n v. Rodway, 235 Fed. 370. T. D. 2152 also held farmers' mutual fire insurance companies to be taxable, but the 1916 Law subsequently expressly exempted such organizations. The 1918 Law and the 1921 Law expressly exempt them.

[6] O. D. 1042, T. B. 38-21-1832.

[7] O. D. 953, T. B. 25-21-1695.

or not any of it is credited to surplus or inures or may inure to the benefit of any private stockholder or individual.[8] To such affidavit should be attached a copy of the charter or articles of incorporation and by-laws of the organization. Upon receipt by the collector of the affidavit accompanied by the copy of the charter, or articles of incorporation and copy of the by-laws, he will inform the organization whether or not it is exempt. If, however, the collector is in doubt as to the taxable status of the organization, he will refer the affidavit and accompanying papers to the commissioner for decision.[9] The character of a corporation must be judged by its articles of incorporation, constitution, and by-laws rather than by the declarations of its officers or the method by which it conducts or has conducted its business.[10] Where there is any doubt as to the status of a corporation under the provisions of the law, and its exempt status has not been established by the treasury department, the annual return should be filed (in blank if desired) and an affidavit attached thereto setting out fully the same information. If the collector is in doubt, he will refer the statement and return to the commissioner for decision and withhold listing for assessment until a decision is reached.[11]

Right of Exemption Must Be Proved on Request. In the absence of the showing indicated in the preceding paragraph, organizations enumerated as exempt may at any time be required to make returns of income or disclose their books of account to a revenue officer for examination in order that the status of the company may be determined.[12] Having once satisfied the collector as to its right to exemption, a corporation is not required to make a return of income or any further showing with respect to its status under the law unless it changes the character of its organization or operations or the purpose for which it was originally created.[13] Collectors keep a list of all exempt corporations to the end that they may occasionally inquire into

[8] Reg. 45, Art. 511; Reg. 33 Rev., Art. 78.

[9] Reg. 45, Art. 511; T. D. 2693.

[10] O. D. 190, T. B. 8-19-328. But see A. R. R. 218, T. B. 32-20-1121. A distinction is made as to religious, charitable, scientific and educational corporations. See A. R. R. 219, T. B. 32-20-1121, as to such corporations.

[11] Reg. 33 Rev., Art. 79. Letter from treasury department dated November 1, 1916; I. T. S. 1919, ¶ 2282.

[12] Reg. 33, Art. 88.

[13] Reg. 45, Art. 511; Mimeograph letter to collectors No. 1148; I. T. S. 1918, ¶ 1201. T. D. 2137.

their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated.[14]

Labor, Agricultural and Horticultural Organizations (first class). The exemption of this class is unconditional. Although the language of the statute is very broad, the law undoubtedly refers only to such organizations as are not organized for profit, have no income inuring to the benefit of their members, and are educational or instructive in character, having for their purpose the betterment of the condition of their members, the improvement of the grade of their products, and the encouragement and promotion of the industries named to a higher degree of efficiency.[15] The following kinds of organization have been held not to fall within this class of exempt organizations:

1. An activity organized for the purpose of affording employment to members of a labor union, which, although owned and controlled by the union, is not a part of the union as such, wages being paid to members employed and profits after paying expenses being turned into the treasury of the union.[16]

2. Organizations for the publication of a breed register the purpose of which is to render a service to the breeders of pure bred live stock.[17]

3. A corporation engaged in the business of raising stock or poultry, or growing grain, fruits, or other products of this character as a means of livelihood and for the purpose of gain.[18]

4. Agricultural corporations owning sugar plantations and disposing of the product thereof.[19]

5. Societies or associations which have for their purpose the holding of annual or periodical race meets and from which profits inure, or may inure, to the benefit of the members or stockholders.[20]

County fairs or like organizations of a quasi-public character, not themselves engaged in agricultural or horticultural

[14] Reg. 45, Art. 511; Reg. 33 Rev., Art. 80.

[15] Reg. 45, Art. 512; Reg. 33 Rev., Art. 73.

[16] O. D. 523, T. B. 21-20-961.

[17] A. R. M. 79, T. B. 33-20-1137. Many of these organizations are very profitable, and while they utilize a portion of their profits for the advancement of the breeds which they register, through prizes and premiums offered for such breeds at the various agricultural fairs, thereby advancing their own interests as well as those of the breeders, they do pay dividends out of what remains. Such organizations might be so organized and operated as to fall under the sixth or seventh class described below.

[18] Reg. 45, Art. 512; Reg. 33 Rev., Art. 74.

[19] T. D. 2090.

[20] Reg. 45, Art. 512; Reg. 33 Rev., Art. 73.

pursuits, and which, by means of awards, prizes or premiums, etc., are designed to encourage better production, and no part of whose income, derived from gate receipts, entry fees, donations, etc., inures to the benefit of any private stockholder or individual, but is used exclusively to meet the necessary expenses of upkeep and operation, are held to be exempt.[21]

Mutual Savings Banks (second class). The mutual[22] savings banks which are exempt are those not having a capital stock represented by shares.[23] A savings bank within the accepted meaning of the term contemplates the ordinary institution of that kind as organized and conducted in accordance with the statutes of the various states. Its manner of investing the savings of depositors is restricted. Furthermore, the funds are received by deposits ordinarily made, rather than by a contract under which there arises a binding duty to make future deposits. Therefore, an organization which receives deposits from its members by contract under which there arises a binding duty to make future deposits, and which is operated for the purpose of speculation rather than for savings, is not a mutual savings bank.[24] A savings fund association having no capital stock represented by shares and deriving its entire income from investments of deposits, such income being divided *pro rata* among all members after deducting operating expenses, the members (who are required to be depositors) electing the board of trustees from their number and these trustees electing officers, is exempt.[25] An association of employees of a company formed for the purpose of enabling its members to save and borrow money, the members of which are limited to the employees of the company who elect annually a board of trustees, has been held exempt under this heading. Each member of this association might subscribe to from 1 to 25 shares of stock which is represented by certificates of deposit, and at the end of the year the money paid in, together with the earnings thereon, was returnable to the members proportionately, but each member had the option of allowing the money to remain on deposit to accumulate further earnings. Any member might borrow from the association on his promissory note, but in no greater amount than remained to his credit, plus a sum equal to one

[21] Reg. 45, Art. 512.

[22] As to what constitutes a mutual purpose see notes 41 and 95 below.

[23] Revenue Act of 1921, 231 (2); Revenue Act of 1918, 231 (2).

[24] O. D. 780, T. B. 4-21-1410.

[25] O. D. 528, T. B. 22-20-974.

[26] O. D. 703, T. B. 43-20-1265.

month's salary, unless the note was secured by satisfactory collateral.[26] A Massachusetts savings bank, otherwise exempt, which establishes an insurance department under the statutes of that state, does not thereby become subject to tax upon the income received by such department.[27]

Fraternal Beneficiary Societies (third class). Fraternal beneficiary societies, orders or associations are exempt (a) if they operate under the lodge system, or if they are for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) if they provide for the payment of life, sick, accident, or other benefits to the members of such society, order or association or their dependents. One important characteristic of this class of exempt corporations is that they must operate under the lodge system, or be for the exclusive benefit of a society operating under such system. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like.[28] Mutual protective associations not operating under a lodge system are not exempt under this provision since they lack one of the characteristics of this class.[29] A fraternal beneficiary society is a society whose members have adopted the same or a very similar calling, avocation, or profession, or who are working in unison to accomplish some worthy object, and who for that reason have bound themselves together as an association or society to aid and assist one another and to promote the common cause. The term "fraternal" can properly be applied to such an association for the reason that the pursuit of a common object usually has a tendency to create a brotherly feeling among those who are thus engaged. The absence of profit in the operation of such an association is not the criterion as to whether it is within the exemption as a fraternal beneficiary society, but the want of a fraternal side or object which it is in some manner organized to promote. A fraternal beneficiary association may be a mutual insurance company, but must be something more. It must be primarily fraternal and must be operated under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system. A society whose single purpose was to write insurance only for members of a certain religious sect who might pass a satisfactory medical examina-

[27] Reg. 45, Art. 513.

[28] Reg. 45, Art. 514; Reg. 33 Rev., Arts. 77 and 239.

[29] Commercial Travelers etc. Ass'n v. Rodway, 235 Fed. 370. This case

tion, and which extended the privilege of insurance to members living apart from their fellows, has been held not to be a fraternity of communicants of a certain sect, but a mutual insurance company writing only such communicants.[30] An incorporated society operating under the lodge system throughout the United States, its charter providing for the union of eligible members into a grand fraternal, beneficiary, educational and patriotic society, assessments being levied upon its members to provide for the payment of sick and death benefits, for disability relief in case of accident and for promoting their social, moral, educational and patriotic advancement, the society deriving income from subscriptions to a daily and a weekly newspaper as well as from job printing and other sources, none of the income inuring to the benefit of any private stockholder or individual, has fraternal and benevolent features, but it is chiefly a patriotic organization interested in the general welfare of its members and its powers are so extensive as to preclude its classification as a fraternal beneficiary society.[31] A travelers' association providing for fixed death benefits to the beneficiaries of the members is held to be a mutual life insurance association rather than a fraternal beneficial society. The law provides no exemption for mutual associations of this character.[32]

Domestic Building and Loan Associations and Co-operative Banks (fourth class). The Revenue Act of 1918 exempted "domestic building and loan associations and co-operative banks without capital stock, organized and operated for mutual purposes and without profit." The 1921 law exempts "domestic building and loan associations substantially all the business of which is confined to making loans to members; and co-operative banks without capital stock organized and operated for mutual purposes and without profit." The Revenue Bill of 1921, as introduced into the House, required, in the case of building and loan associations, that they should be operated *exclusively* for the purpose of making loans to members. As finally passed the bill requires that *substantially all* the business be confined to making loans to members. The purpose of the change in the language of the House bill was stated in the report of the committee on ways and means as follows: "Under the present law some mortgage and investment companies have been able to

contains an extended discussion on the distinction between a mutual association and a fraternal association.

[30] O. D. 690, T. B. 42-20-1250.

[31] O. D. 508, T. B. 20-20-940.

[32] O. D. 63, T. B. 1-19-88.

obtain this exemption by operating in the guise of building and loan associations. By limiting the exemption to 'domestic building and loan associations, operated exclusively for the purpose of making loans to members,' this abuse will be prevented." The regulations issued under the 1918 Law required that to be exempt, building and loan associations should accumulate their funds for the primary business of making loans to its members for the purpose of building or acquiring homes. It will be seen that the present law is, in effect, largely an enactment of such regulations. Under the 1918 Law the following rulings and regulations were made:

In general, a building and loan association entitled to exemption is one organized pursuant to the laws of the United States, of some state or territory thereof, which accumulates funds for the primary business of making loans to its members for the purpose of building or acquiring homes, and in which the members of the association share in the profits on substantially the same footing. It is essential that the association should be (a) mutual; (b) organized and operated for the accumulation of funds to be loaned primarily to members for home building.[33] When a building and loan association has no other features which render it liable to income tax, it will ordinarily not be subject to tax merely because: (1) It has paid-up shares which are (a) preferred as to earnings and (b) have a definite rate of interest which may be higher than the rates of dividends paid on other stock.[34] (2) It borrows large sums of money (accepting deposits is considered as borrowing), which it uses primarily for loans to members, the dues paid by members being entirely inadequate for this purpose.[35] (3) In times of small demand it loans considerable sums to nonmembers from or invests association funds which would otherwise lie idle and unproductive.[36] (4) The amount of prepaid or full-paid stock is

[33] Reg. 45, Art. 515, as amended by T. D. 3179, T. B. 27-21-1716. The essential features of a building and loan association are stated in Folk v. State Capital Ass'n, 214 Pa. 529, 63 Atl. 1013. Conducting an insurance agency by a building and loan association will defeat its exemption. (O. D. 1129, T. B. 49-21-1965.)

[34] Reg. 45, Art. 515, as amended by T. D. 3179, T. B. 27-21-1716, Park View Building & Loan Ass'n v. Herold, 203 Fed. 876, 210 Fed. 577; T. D. 1941. This was not true under the 1909 Law. (See footnote 41.)

[35] Reg. 45, Art. 515, as amended by T. D. 3179, T. B. 27-21-1716; Bellefontaine Building & Loan Co. v. McMaken, 216 Fed. 526.

[36] Reg. 45, Art. 515, as amended by T. D. 3179, T. B. 27-21-1716; Central Building, Loan & Savings Co. v. Bowland and Bellefontaine Building & Loan Co. v. McMaken, 216 Fed. 526. This also was not true under the 1909 Law (see footnote 41). A building and loan association which loans its

disproportionate to running or installment stock, provided the issuance of such prepaid or full-paid stock is incidental to the furtherance of the main business of the association; that is, that it is intended to provide a fund from which loans may be made primarily to persons subscribing to the running or installment stock to enable them to acquire or build homes.[37] Where, however, the facts show that a building and loan association is borrowing large sums of money from nonmembers, with no reference to the borrowing needs of its members, and is in turn loaning these sums to nonmembers, the number of depositors being disproportionate to the number of members, and the amounts loaned to nonmembers being disproportionate to the amount loaned to members, such association will be deemed to be taxable and will be granted exemption only upon a satisfactory showing to the commissioner that it is, in fact, a bona fide building and loan association within the meaning of this article.[38] When a building and loan association charges a commission on all money loaned, in lieu of a membership fee, and does not charge a membership fee to nonborrowing members, such commission or membership fee is held to be in the nature of additional interest for the use of the money loaned and is insufficient to deny the association the exemption to which it is otherwise entitled.[39] Where a large proportion of the loans of an association are made upon such securities as stocks, automobile notes and personal endorsements and only a small proportion upon real estate, it is held that such an association is not a domestic building and loan association within the meaning of the law and must file returns of annual net income and pay any tax shown to be due thereon.[40] If a corporation by any other name is carrying on an exclusive building and loan business, before it is entitled to exemption it will be incumbent upon it to show to the satisfaction of the commissioner that it is in fact a

funds to nonmembers, on indorsed notes, a very small amount only being secured by real estate, and divides the profits among the holders of the paid-up certificates, these being the only members of the association participating in the management and in the profits, is held to be engaged in business in the nature of a banking business, and does not come within this exemption. (O. D. 768, T. B. 1-21-1375.)

[37] Reg. 45, Art. 515, as amended by T. D. 3179, T. B. 27-21-1716; see S. 1140, T. B. 19-19-449, O. D. 573, T. B. 27-20-1043; Sol. Op. 78, T. B. 48-20-1325.

[38] Reg. 45, Art. 515, as amended by T. D. 3179, T. B. 27-21-1716.

[39] O. D. 744, T. B. 49-20-1336.

[40] O. D. 1088, T. B. 44-21-1900.

building and loan association.[41] Co-operative banks without capital stock organized and operated for mutual purposes and without profit are exempt. Credit unions, such as those organized under the laws of Massachusetts, are in substance the

[41] Reg. 33 Rev., Art. 70. The 1909 and 1913 Laws provided that "domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members" should be exempt. The 1916 Law contained the following exemption: "Domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit." Under the 1916 Law it was ruled that mutuality in operation and in the distribution of profits and benefits was essential to exemption; that in order to come within the exempted class such associations must not only be domestic, but they must be organized and operated exclusively for mutual purposes and without profit, that is, all profits and benefits provided for in the articles of association and by-laws must be ratably distributed among all the members regardless of the kind of stock held, according to the amount of money they had on deposit; and that an association issuing different classes of stock upon which different rates of interest or dividends were guaranteed or paid, was not in the exempt class. (Reg. 33, Art. 87.) Under the 1909 Law it was ruled that building and loan associations were not exempt if they loaned money to others than their members, thus doing a business similar to that engaged in by banks or trust companies; and that building and loan associations which received sums of money on deposit not in payment of stock, and on which the depositor received a fixed rate of interest, regardless of the earnings of the association, were conducting a business similar to a banking business and were therefore subject to tax unless they fell within the class of co-operative banks. (T. D. 1655.) Under the 1909 Law it was decided that a building and loan association was exempt although it issued both prepaid and installment stock, but that one issuing preferred stock was not exempt. (Pacific Bldg. & Loan Ass'n v. Hartson, 201 Fed. 1011.) In Herold v. Parkview Bldg. & Loan Ass'n, 203 Fed. 876, the association issued two varieties of stock, one known as prepaid stock on which the full par value of $200 per share was paid by the holder at the time of the issuance of the stock, and upon which the company paid to the holder out of the profits of the association the sum of 5% per annum in lieu of participation by said stockholder in the general profits of the association, and a second stock known as installment stock whereon the holder paid one dollar per share per month and to which was added the proportionate share of the profits of the association after deducting expenses until the aggregate of payments and profits equaled the sum of $200, when the said sum was paid to the holder and the shares retired. The prepaid stock could be cancelled by the corporation at any time upon thirty days' notice and payment of the value thereof together with interest at the rate of 5% from the date of last payment of interest, and each holder of such stock could likewise upon thirty days' notice tender his certificate and require payment from the association. The association borrowed no money from individuals whether members or nonmembers, loaned no money to persons other than members of the association, but borrowed according to its business demands from a local bank. The association was organized under the Act of April

same as co-operative banks, and when organized and operated without capital stock, for mutual purposes, and without profit are likewise exempt.[42]

Cemetery Companies (fifth class). Under the 1918 Law "cemetery companies owned and operated exclusively for the benefit of their members" were exempt. The present law adds the words: "or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual.[43] Under the 1918 Law the following rulings were made: A cemetery company having a capital stock represented by shares, or which is operated for profit or for the benefit of others than its members, does not come within the exempted class. A cemetery company of which all lot owners are members, issuing preferred stock entitling the holder to a semi-annual dividend of 4 per cent., and whose articles of incorporation provide that the preferred stock shall be retired at par as soon as sufficient funds are realized from sales and that all funds realized in addition thereto shall be used by the company for the care and improvement of the cemetery property, is within the exemption.[44] The word "members" as used by the law, means "lot owners".[45]

Religious, Charitable, Scientific, Literary, and Educational Corporations (sixth class). This exemption applies under the 1918 Law only to a corporation or association. Under the present law it applies, as well, to "any community chest, fund, or foundation" subject to the same limitations applying to corporations. The Revenue Act of 1921 adds the term "literary" to the purposes for which such organizations must be organized and operated. It does not include the case of a trust, under which the trustee is authorized to use the trust property for religious purposes. In order to be exempt the corporation or association

8, 1903 (Public Laws, p. 457), of New Jersey. It was held that mutual benefit does not necessarily mean equal benefit; that a building and loan association is organized and operated for the mutual benefit of its members when they share in the profits on substantially the same footing; and that exact equality is probably not possible where part of the stock is prepaid and part is installment, but an approximate equality sufficiently close for all purposes is certainly not beyond the reach of calculation.

[42] Reg. 45, Art. 515, as amended by T. D. 3179, T. B. 27-21-1716.

[43] Revenue Act of 1918, § 231 (5); Revenue Act of 1921, § 231 (5).

[44] Reg. 45, Art. 516; Reg. 33 Rev., Art. 71.

[45] Sol. Op. 120, T. B. 39-21-1846.

must meet three tests: (a) it must be organized and operated for one or more of the specified purposes; (b) it must be organized and operated exclusively for such purposes; and (c) no part of its income must inure to the benefit of private stockholders or individuals.[46] The courts favor tax exemptions which pertain to charitable, religious, or educational institutions upon the theory that such institutions relieve burdens of the government.[47] The term "organized," as used in the provision granting exemption to this class of corporations, refers to the real substance and intent of the organization, and not to its mere form, the charter and by-laws merely giving rise to presumptions which may be affirmed or rebutted by extraneous evidence.[48] The word "private" refers to a stockholder or individual in his private capacity as distinguished from a public capacity. Dividends inure to a stockholder in his private capacity when they inure to him separate from the public and not as an official or representative of the public.[49] The term "charitable" has been given a very broad meaning by the courts, but it is noticeable that the decisions applying the broadest meaning are in cases involving "charitable uses," that is, where there is a trust for a charitable purpose. It is, of course, expedient to uphold such trusts where a construction of the law will possibly admit it.[50] Education, in a broad sense and with reference to man, comprehends all that disciplines and enlightens the understanding, corrects the temper, cultivates the taste, and forms the manners and habits.[51] It is the process of developing and training the powers and capabilities of human individuals.[52] The prime purpose of education is to benefit the individual.[53] On the other hand, the primary purpose of propaganda is much more narrow. Propaganda is that which propagates the tenets or principles of a particular doctrine by zealous dissemination.[54] It is a matter of common knowledge that propaganda in the popular sense is disseminated not primarily to benefit the individual at whom it is directed, but to accomplish the purpose or purposes of the person instigating it.

[46] Reg. 45, Art. 517; Reg. 33 Rev., Art. 67.

[47] O. D. 510, T. B. 20-20-942; Congregational Church Society v. Board, 290 Ill. 108, 125 N. E. 7.

[48] A. R. R. 219, T. B. 32-20-1121.

[49] T. B. R. 33, T. B. 8-19-329.

[50] S. 1246, T. B. 8-20-755.

[51] Century Dictionary, p. 1845.

[52] Mt. Herman Boys' School v. Gill, 145 Mass. 139, 13 N. E. 354, 357.

[53] Century Dictionary, p. 1845.

[54] Century Dictionary, p. 4774.

This is a very material difference. The solicitor of the treasury department is of the opinion that it was Congress' intention, when providing for the deduction of contributions to educational corporations, not to benefit and assist the aims of one class against another, not to encourage the dissemination of ideas in support of one doctrine as opposed to another, to the profit of one class and to the detriment perhaps of another, but to foster education in its true and broadest sense, thereby advancing the interest of all, over the objection of none.[55]

The following types of organization are exempt under this class:

1. A branch of the Y. W. C. A., established for the purpose of marketing the needlework of self-supporting women, which pays to the producers the full selling price of the goods sold, less a certain commission which only partially defrays the running expenses of the enterprise, the deficit being derived from income of the Y. W. C. A. and from voluntary contributions.[56]

2. An organization incorporated for the purpose of establishing and maintaining a day nursery for young children whose parents are obliged to work and have no means to provide care for their children during the day, and deriving its income from subscriptions and donations, and a small amount from securities, all of which is used in promoting the activities of the nursery.[57]

3. An incorporated publishing house, without capital stock, owned and controlled by a religious denomination, its business consisting strictly of printing religious publications in the form of books, tracts, Sunday school lessons, catalogues, periodicals, etc., and distributing them to the various branches of the church and members of congregations, no business being done for the general public.[58]

4. An organization such as the Teachers' Insurance and Annuity Association of America, which though in form a business insurance company was required to adopt this form in order to issue non-participating policies under the laws of New York.[59]

[55] S. 1362, T. B. 22-20-971.

[56] O. D. 509, T. B. 20-20-941.

[57] O. D. 340, T. B. 29-19-630.

[58] O. D. 510, T. B. 20-20-942. It was clear that the predominant purpose of the publishing house involved in this decision was to advance the cause of Christianity. It was conducted at a profit, none of the income inured to the benefit of any private individual, being paid over in its entirety to the treasurer of the church for the exclusive benefit of the church.

[59] A. R. R. 218, T. B. 32-20-1121.

5. A corporation organized and operated for the purpose of preventing the employment of children in injurious occupations.[60]

6. An association for the relief of the families of clergymen, even though the latter make a contribution to the fund established for this purpose; or for furnishing the services of trained nurses to persons unable to pay for them; or for aiding the general body of litigants by improving the efficient administration of justice.[61]

7. An association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; an association to increase knowledge of the civilization of another country; and a chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose.[62]

8. An association for the scientific study of law, to the end of improvement in its administration.[63]

9. A private corporation without capital stock organized and operated under state laws and managed by a board of trustees for the purpose of conducting a school to educate and train men and women in those subjects that will prepare them for practical business and commercial and industrial occupations, deriving its income from tuition fees paid by students attending its courses, the balance remaining after payment of expenses being placed in an operating fund to meet operating expenses in the future, any amount in excess of 25 per cent. of the current year's income being placed in a students' loan fund from which deserving students may borrow money for the purpose of pursuing a course of study in the school, and no part of the earnings of the school inuring to the benefit of any individual or individuals connected with the corporation in any manner whatever, the by-laws providing that no remuneration of any kind shall be paid to the board of trustees for their services as such.[64]

The following types of organizations are not exempt under this class:

1. An actively operating railroad which turns over all of its income to a charitable institution as a dividend.[65]

[60] O. D. 705, T. B. 43-20-1267.
[61] Reg. 45, Art. 517.
[62] Reg. 45, Art. 517.
[63] Reg. 45, Art. 517.
[64] O. D. 1102, T. B. 46-21-1923.
[65] O. D. 60, T. B. 1-19-85.

2. A corporation conducting an educational institution all of whose stockholders are directors in the company, and which pays dividends to its stockholders, the surplus earnings over a fixed rate paid as dividends being invested as they accrue in grounds, buildings, and equipment needed in the business.[66]

3. An incorporated educational institution whose only source of income is from tuition and sale of uniforms and supplies to its students, and no part of the net income of which is distributed as dividends, but is expended in acquiring additional buildings and equipment, is not entitled to exemption, the corporation being considered as capitalizing its earnings by acquiring new buildings and equipment.[67]

4. A corporation organized for the purpose of acquiring and holding title to land and erecting thereon suitable buildings for conducting an assembly or chautauqua, religious, educational, and recreational in character, deriving income from ground rentals, sales of tickets, advertising space, hotel accommodations, etc., all expenditures being made in connection with hiring talent and entertainment and the upkeep of buildings and grounds, none of the income of which is paid to any stockholder or individual, although the charter and by-laws do not prohibit such payment.[68]

5. A corporation organized and operated exclusively for the purpose of erecting and maintaining monuments or other like memorials no part of the earnings of which inures to the benefit of any private stockholder or individual.[69]

6. An association organized and operated for the purpose of furthering the enactment of prohibition laws, the selection of prohibition officials, and the nomination and election of political candidates favorable to its work.[70]

7. The pension fund organization of a corporation the object of which is the payment of annuities to member employes in the event that they are incapacitated by infirmity from performing their duties to the corporation, or in the event of their death, and the payment of annuities to the widows or dependents of

[66] T. B. R. 33, T. B. 8-19-329.

[67] O. D. 293, T. B. 23-19-548.

[68] A. R. M. 36, T. B. 11-20-786. If the corporation involved in this decision should have gone out of existence, the stockholders would have benefited directly through the distribution of the assets, as well as through any appreciation of such assets.

[69] S. 1246, T. B. 8-20-755. The status of such corporations as have additional purposes involving a positive dissemination of knowledge will be determined on proper facts submitted in each case.

[70] O. D. 703, T. B. 43-20-1266.

members who had been in the uninterrupted service of the corporation for ten years or more and have attained the age of sixty-four years; the funds out of which annuities are paid consisting of the contributions of members.[71]

8. A society designed to encourage the performance of first class orchestral music, the purpose of which is to encourage a high grade of entertainment.[72]

9. A school which, though devoted solely to educational purposes, is operated for the pecuniary profit of certain stockholders, even though all such stockholders are officers, directors and teachers in the institution.[73]

10. An ordinary common-law trust created by a will for the purpose of erecting schools which does not amount to an "association".[74]

11. A lyceum and chautauqua association organized to take over the assets of a partnership for the purpose of promoting the intellectual, social, physical, moral and nonsectarian religious welfare of the people in the places where it operates and especially in the United States, its income being received from admission charges to its entertainments and being used first to defray expenses of operating; second to the payment of the members of the partnership for assets purchased, and, third, to build up a surplus, the members of the partnership whose assets were taken having been made life members of the board of trustees.[75]

12. A hospital association incorporated under the laws of a state to build, own, lease, acquire, and operate a hospital to furnish and provide medical, surgical and hospital services and care to all employes of other corporations, persons, or partnerships with whom contracts may be made; said services being intended to take care of the needs of sick and injured employes requiring and entitled to such care by virtue of membership in said corporations and in conformity to the provisions of the by-

[71] A. R. R. 477, T. B. 18-21-1610. The solicitor founded this decision upon the consideration that the pension fund was not for the benefit of an *indefinite* number of persons. (See St. Clement v. L'Institut Jacques Cartier, 95 Maine 493, 50 Atl. 376; Young Men's Society v. City of Fall River, 160 Mass. 409, 36 N. E. 57; Franta v. Bohemian Union, 164 Mo. 304, 63 S. W. 1100).

[72] Reg. 45, Art. 517.

[73] Kemper Military School v. Crutchley, 274 Fed. 125.

[74] A. R. M. 104, T. B. 1-21-1376. Neither were the expenses of operating the schools permitted to be deducted from the gross income of the trust as ordinary and necessary expenses; they constituted the expenditure of the trust moneys for the very purpose for which the trust was created.

[75] O. D. 1077, T. B. 43-21-1886.

laws of the corporation and the care of injured employes as contemplated and provided for in the laws of the state and the rules, regulations, and practices now or hereafter promulgated by the state medical aid board; the corporation also contemplating hospital services and care for the families of employees and for other persons; the income of the association being received from the corporations with which it has contractual relations, from the medical aid department of the state for services to injured employees who do not have contract arrangements, and from direct payments by patients and no patients being treated free, but where destitute patients have been admitted as objects of public charge the services being rendered at cost to the municipal corporation paying for such services.[76]

13. A religious corporation owning a large quantity of farm land and working it, and also manufacturing and selling clothing and other articles for profit, even though its property is held in common and its profits do not inure to the benefit of individual members of the society. It does not prevent exemption that private individuals, for whose benefit a charity is organized, receive the income of the corporation or association. The statute refers to individuals having a personal and private interest in the activities of the corporation, such as stockholders. If, however, a corporation issues "voting shares," which entitle the holders upon the dissolution of the corporation to receive the proceeds of its property, including accumulated income, the right to exemption does not exist, even though the by-laws provide that the shareholders shall not receive any dividend or other return upon their shares.[77]

Business Associations (seventh class). Business leagues, chambers of commerce and boards of trade are conditionally exempt; that is, those not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual are exempt. A business league is an association of persons having some common business interest, which limits its activities to work for such common interest and does not engage in a regular business of a kind ordinarily carried on for profit. Its work need not be similar to that of a chamber of commerce or board of trade.[78]

The following types of organizations are business leagues within the purview of the statute:

[76] O. D. 993, T. B. 33-21-1769.

[77] Reg. 45, Art 517; Reg. 33 Rev., Art. 67.

[78] Reg. 45, Art. 518.

1. A clearing house association not organized for profit, no part of the net income of which inures to any private stockholder or individual, provided its activities are limited to the exchange of checks and similar work for the common benefit of its members.[79]

2. An association of persons engaged in the business of carrying freight and passengers by boats propelled by steam, which is designed to promote the legitimate objects of such business, all the income of which is derived from membership dues and is expended for office expenses and the salary of the secretary-treasurer.[80]

3. A corporation organized for the purpose of fostering, developing and promoting scientifically a certain industry, with no capital stock represented by shares and not authorized to invest funds for profit or to make any distribution thereof by way of dividends, the funds for maintaining the association being derived solely from assessments against individual member firms and dues with the exception of interest on bank deposits and Liberty bonds purchased from excess surplus funds, which in accordance with the by-laws are required to be refunded proportionately to those contributing the funds, no other securities being owned by the association, and the interest on the Liberty bonds not being credited or distributed to any member.[81]

4. An unincorporated association formed for the purpose of ascertaining the causes of losses sustained through navigation of vessels belonging to its members, thereby reducing such losses, any excess of fees, assessments, and interest received over current expenses and losses sustained by members being returned to members on a *pro rata* basis.[82]

The following types of organizations are not entitled to exemption under this heading:

1. An association engaged in furnishing information to prospective investors to enable them to make sound investments, since its members have no common business interest.[83]

2. An incorporated cotton exchange whose shares carry the right to dividends.[84]

3. An association of credit men acting through its credit interchange bureau and its adjustment bureau as receiver and

[79] Reg. 45, Art. 518.
[80] Reg. 45, Art. 518.
[81] O. D. 522, T. B. 21-20-960.
[82] O. D. 61, T. B. 1-19-86.
[83] Reg. 45, Art. 518.
[84] Reg. 45, Art. 518.

trustee for insolvent or embarrassed businesses and otherwise protecting the interests of its members in excess of insolvency and producing for its members larger dividends from bankrupt or embarrassed estates than they would otherwise receive; for these services charging a fee covering the cost thereof, the association's fees and disbursements in connection with these activities amounting to about 45 per cent. of its total budget.[85]

Civic Organizations (eighth class). Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare are exempt.[86] A corporation having capital stock and possessing a charter which authorizes it to buy, improve and sell real estate is organized for profit within the meaning of the statute and is not exempt from tax as a civic league or organization, even though it no longer exercises such powers for profit and is operated exclusively for the promotion of social welfare.[87]

Clubs (ninth class). Clubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes are exempt if no part of the net income inures to the benefit of any private stockholder or member.[88] This exemption applies to practically all social and recreation clubs which are supported by membership fees, dues and assessments. If a club, by reason of the comprehensive powers granted in its charter, engages in traffic, in agriculture, or horticulture, in the sale of real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes. It thus becomes a business or commercial enterprise, and any profit realized from such activities is subject to the tax, and the club so operated must make returns of income.[89] A provision in the by-laws of a country club, that, in the event of dissolution, the holder of a life membership shall participate in the distribution of the assets of the club after its other debts are paid and before any sums are paid to either regular members or shareholders, is not alone sufficient to make the club liable to tax.[90]

[85] O. D. 786, T. B. 5-21-1419.

[86] Reg. 33 Rev., Art. 67.

[87] Reg. 45, Art. 519.

[88] Reg. 33 Rev., Arts. 67 and 72. T. D. 2090. Letter from treasury department dated February 12, 1916; I. T. S. 1918, ¶ 1194. Such clubs were held to be exempt under the 1913 Law, although that law did not contain the express exemption which appears in the 1916 and 1918 Laws. (Letter from treasury department dated May 4, 1914; I. T. S. 1918, ¶ 1192.)

[89] Reg. 33 Rev., Art. 72; Reg. 45, Art. 520.

[90] S. 958, T. B. 1-19-81.

The following clubs are exempt:

1. A club formed for the purpose of providing for the members thereof a suitable meeting place, a library, and a dining room where meals will be furnished to the members, the income being derived from membership dues and the receipts for food, wine and cigars purchased by members, and no part of the net earnings inuring to the private benefit of any member.[91]

2. A club organized for the purpose of promoting the principles and interests of a certain political party, deriving its income from membership dues and donations which are used for the purpose of defraying expenses necessary to the operation and upkeep of its rooms, no part of which inures to the benefit of any of its members.[92]

3. An automobile club organized for the purpose of promoting the improvement of roads and boulevards, and other matters of benefit to automobile owners and drivers, such as signposting roads and securing legislation of benefit to automobile owners and drivers, its income being derived from membership fees and subscriptions, no part of which inures to the benefit of any private stockholder or individual.[93]

4. An incorporated club, composed of employees of a corporation, organized for social purposes, its only source of income being the initiation fee and this being expended solely for entertainments; in which certain members, called participating members, made contributions to a Christmas fund which was invested by the executive committee and distributed just before Christmas each year.

Mutual or Co-operative Organizations of a Local Character (tenth class). Farmers' or other mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, and like organizations of a purely local character, the income of which consists solely of assessments, dues and fees collected from members for the sole purpose of meeting expenses incurred in pursuance of the purpose for which the company is organized, are specifically exempt. It should be noted that the essential features of this class are as follows: (a) They must be mutual or co-operative; (b) they must be of a purely local character; (c) the income must be solely from assessments, dues and fees collected from members, and such assessments, dues and fees must be used for the sole

[91] O. D. 108, T. B. 2-19-162.
[92] O. D. 280, T. B. 20-19-513.
[93] O. D. 643, T. B. 34-20-1152.

purpose of meeting expenses,[94] incurred in pursuance of the purposes for which the companies are organized. It is necessary to exemption that the income of the company be derived solely from assessments, dues and fees collected from members. If income is received from other sources, the corporation is not exempt, even though its additional income is tax exempt. Income, however, from sources other than those specified does not prevent exemption where its receipt is a mere incident of the business of the company. Thus the receipt of interest upon a working bank balance, or of the proceeds of a sale of badges, office supplies or equipment, will not defeat the exemption. The same is true of the receipt of interest upon Liberty bonds, where they were purchased as a patriotic duty and were afterwards sold. Where, however, such bonds are bought as a permanent investment, the receipt of the interest destroys the exemption. The receipt of what is in substance an entrance fee, charged by a mutual fire insurance company as a condition of membership, does not render the company taxable, although this fee is called a "premium." But the issuance of policies for stipulated cash premiums prevents exemption.[95] The phrase "of a purely local

[94] Reg. 33 Rev., Arts. 69 and 239.

[95] Reg. 45, Art. 521. In connection with this class of exempt corporations the decision in the case of Niles v. Central etc. Ins. Co., 252 Fed. 564, is interesting. The case arose under the Act of Oct. 22, 1914 (38 Stat. 762, c. 331) imposing a stamp tax on insurance policies, and contained an exemption reading, "provided that purely co-operative or mutual fire insurance companies or associations carried on by the members thereof for the protection of their own property and not for profit, shall be exempted from the tax herein provided." A mutual fire insurance company was organized under the laws of Ohio, which required the company to (1) charge a cash premium payable at the time of delivery of policies, and (2) maintain an unearned premium reserve of a definite percentage of the cash premiums on unexpired risks, and which permitted the company to (1) maintain a surplus in excess of the above reserve, as an additional security to policyholders, and (2) earn interest on both the above reserve and surplus by investing them; the cash premium in excess of the amount estimated as sufficient for the protection and payment of losses at the expiration of each policy being returnable to the policyholder. The company was held to fall within the exemption above quoted, because its primary purpose was not to derive incidental profit from interest on its reserve and surplus, or to undertake investments on behalf of its members, but solely to protect more effectively the property of its members. The court said: "The distinction drawn in the act is between those mixed mutuals, which, though commonly called mutuals, are in fact also doing a non-mutual business for profit, and the strictly mutual companies; not between the mutuals which carry a reserve and surplus, and those which levy assessments only after each loss. A mere incidental profit earned by way of interest on its invested safety funds, or

character" qualifies only "like organizations". An association is not "of a purely local character" when its business activities are not confined to a particular community, place, or district. The business operations of such a "like organization" might be confined to a particular community, place, or district, thus bringing it within the meaning of the words "purely local character," and yet cover portions of more than one state. The words "purely local character" imply a single locality, irrespective of political subdivisions. But when its activities cover half the counties of two states, and part of two other states, such districts being two or three hundred miles apart; or when its activities cover a whole state and part of another state, they are of "general" rather than of "local" character and the associations are not exempt from taxation.[96]

The following kinds of organization fall within this class of exemption:

1. An incorporated insurance association for the purpose of permitting automobile owners to exchange contracts of insurance and indemnity without becoming jointly liable as subscribers on any risks, confining its activities within the state of incorporation and its only source of income being from assessments, dues and fees collected from members for the sole purpose of meeting expenses.[97]

2. A reciprocal indemnity exchange incorporated by a number of manufacturers to insure their businesses against fire loss on the reciprocal and inter-insurance plan through an attorney in fact, having the power to issue policies, collect premiums, and adjust losses, the business of which is not conducted for profit, and the contract of insurance or power of attorney signed by each member providing that there shall be no capital stock or joint funds, but that each subscriber shall act individually and shall deposit a fixed amount to meet losses, any balance being returnable at the end of the period of insurance.[98]

3. A farmers' mutual fire and lightning insurance company making assessments on its members for the sole purpose of meeting estimated future losses and expenses, and which has an unexpended balance of the assessment or assessments so

on its bank balances, does not change the purely mutual character of the company, or indicate that its business, though thus earning a profit, is 'carried on for profit.' "

96 O. 792, T. B. 1-19-82.

97 O. D. 312, T. B. 25-19-586.

98 O. D. 538, T. B. 23-20-989.

made on hand at the end of the year, which balance is retained by the company to meet losses and expenses in the ensuing year.[99]

4. A local exchange or association to insure the owners of automobiles against fire, theft, collision, public liability and property damage, is exempt, since it performs functions of the same character as a mutual fire insurance company.[100]

5. A local reservoir and ditch company.[101]

The following kinds of organization do not fall within this class:

1. A casualty insurance association organized for the purpose of insuring its members throughout the state, and not within a geographical subdivision thereof, and issuing policies of insurance for stipulated cash premiums instead of depending upon assessments solely for the payment of its insurance liabilities, and its annual surplus over all expenditures, losses, etc., being returnable to the members in the shape of annual dividends, and the fund for the payment of salaries and other operating expenses being a large percentage of cash received by it, and which makes permanent investments of large amounts in Liberty bonds of the United States.[102]

2. A mutual irrigating ditch company providing for its expenses by assessment against its stockholders and receiving no other income except certain rents derived from the use of its surplus water, since its income does not consist solely of assessments, dues, and fees collected from members.[103]

3. A mutual liability insurance company deriving its income from premiums and assessments of its members which are used to defray operating expenses and to indemnify its policyholders against amounts which they are required to pay under a workmen's compensation law.[104]

4. An association of manufacturers incorporated as a reciprocal indemnity exchange to insure their business against fire loss on the reciprocal and inter-insurance plan through an attorney in fact having the power to issue policies, collect premiums, and adjust losses; the subscriber's contract providing that there shall be no joint funds but this provision not being carried out in letter or spirit; advance payments being made

[99] Sol. Op. 99, T. B. 15-21-1564.

[100] Reg. 45, Art. 521.

[101] Reg. 45, Art. 521.

[102] O. 790, T. B. 1-19-83.

[103] O. D. 318, T. B. 26-19-594.

[104] O. D. 252, T. B. 14-19-437.

direct to the exchange and charged in the nature of advance premium deposits; policies being subject to cancellation on a short rate basis.[105]

5. A telephone clearing association, whose business is to apportion toll rates between independent telephone companies handling the same calls and whose income consists of compensation paid by such companies and receipts from the sale of form blanks.[106]

Associations for Marketing Produce and Purchasing Supplies (eleventh class). Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expense, on the basis of quantity of produce furnished by them, are exempt.[107]

The 1921 law adds a new provision exempting such associations organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, less necessary expenses.[108] The following rulings were made under the 1918 law. Co-operative associations, in order to come within this exemption, must establish to the satisfaction of the collector or commissioner the fact that, for their own account, they have no net income, their business being to market the products of their members, and that the entire proceeds of such marketing, less necessary selling expenses, are turned back or paid to the members on the basis of the quantity of produce furnished by them—quality and grade being considered—as the purchase price of such produce. If in the course of their business such associations purchase for cash at a stipulated price articles or produce with a view to selling them for gain, it will be held that such associations are organized for profit and such associations will be required to make returns of annual income and include therein, for the purpose of the tax, all income derived from such transactions. If amounts paid to members are based solely upon the quantity of produce furnished, such amounts may be deducted from the gross proceeds of sales, and the taxable net income will be the amount of earnings passed to surplus, or distributed or distributable among members on the basis of their stock holdings.[109]

105 O. D. 866, T. B. 14-21-1551; see also L. O. 1063, T. B. 19-21-1626.

106 Reg. 45, Art. 521.

107 Revenue Act of 1921, § 231 (11); Revenue Act of 1918, § 231 (11).

108 Revenue Act of 1921, § 231 (11).

109 Reg. 33 Rev., Art. 75; S. 952, T. B. 1-19-84.

The following types of organization have been held exempt under this class:

1. A co-operative dairy company engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among members, upon the basis of the quantity of milk or butter fat furnished by members; but not if the proceeds of the business are distributed in any other way than on such a proportionate basis.[110]

2. A corporation organized to act as sales agent for farmers and having a capital stock on which it pays a fixed dividend amounting to legal rate of interest and all of the capital stock of which is owned by such farmers.[111]

The following types of organization are not exempt:

1. A farmers' association which in accounting to farmers furnishing products for the proceeds of sales deducts more than the necessary selling expenses incurred.[112]

2. A co-operative association acting as purchasing agent, but such an association may exclude from gross income rebates made to purchasers whether or not members of the association; any profits made from nonmembers and distributed to members in the guise of rebates being, of course, subject to tax.[113]

3. An incorporated fruit growers' association conducting its business at a profit, thereby accumulating a fund out of which dividends are paid which allows persons who are not fruit growers to acquire stock and thus share in the proceeds; but such a union may deduct from gross income amounts periodically returned to members as a refund of profits on business transacted with them and proportionate to the amount of such business.[114]

Corporations Owned by Exempt Corporations (twelfth class). Corporations organized for the exclusive purpose of holding title

[110] Reg. 45, Art. 522; O. D. 191, T. B. 8-19-330. Under the 1913 Law, which did not contain the foregoing exemption, it was held that co-operative dairy associations, whether issuing capital stock or not, were not exempt as agricultural organizations. In the preparation of their returns such associations were permitted to deduct from gross income the amount actually paid to members and patrons for milk, but any amount retained at the end of the year over and above expenditures was taxable as income. (T. D. 1996; see also Reg. 33 Rev., Art. 76.)

[111] Sol. Op. 57, T. B. 35-20-1172.

[112] Reg. 45, Art. 522.

[113] Reg. 45, Art. 522. Purchasing associations are exempt under the present law.

[114] O. D. 64, T. B. 1-19-89.

to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to organizations which are themselves exempt from the income tax are also exempt.[115] A corporation managed by five trustees, operating a theater building erected as a memorial, the net income from which is to be turned over to a city, for its use and benefit, is not one organized for the "exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof less expenses to an organization which itself is exempt from income tax."[116] A co-operative store managed by a university for the purpose of selling to its students supplies of every kind, and in case of dissolution its property reverting to the trustees of the school, does not come within the class of corporations organized for the exclusive purpose of holding title of property, collecting income therefrom, and turning over the entire amount thereof. It is actively engaged in the operation of a business in which profits are realized.[117]

Federal Land Banks and National Farm-Loan Associations (thirteenth class). Federal land banks and National Farm-Loan Associations as provided in § 26 of the act of July 17, 1916, entitled "An act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create government depositaries and financial agents for the United States, and for other purposes," are exempt.[118]

Personal Service Corporations (fourteenth class). Since the stockholders of personal service corporations are taxable in the same manner as the members of a partnership,[119] personal service corporations as such are exempt from tax.[120] Since personal service corporations are taxed as other corporations after December 31, 1921, this exemption is not effective after that date.[121]

Joint-Stock Land Banks. Joint-stock land banks were unconditionally exempt under the 1916 law, as amended, as to income derived from bonds or debentures of other joint-stock land banks or any federal land bank belonging to such joint-stock land bank.

115 Such corporations were held to be taxable under the 1913 Law in the absence of express provisions in that law for their exemption. (T. D. 2137.)

116 O. D. 177, T. B. 7-19-300.

117 O. D. 65, T. B. 1-19-90.

118 Revenue Act of 1921, § 231 (13); Revenue Act of 1918, § 231 (13); Reg. 45, Art. 74; Reg. 33 Rev., Art. 68.

119 Revenue Act of 1921, § 218 (d); Revenue Act of 1918, § 218 (e).

120 Revenue Act of 1921, § 231 (14); Revenue Act of 1918, § 231 (14).

121 Revenue Act of 1921, § 231 (14).

They were taxable, however, as to income from other sources and consequently it would seem they were not exempt from the requirement of making a return of annual income, since the exemption from making returns applied only to corporations not subject to the tax. Neither the 1918 law nor the present law includes joint-stock land banks in the list of exempt organizations.[122]

[122] Cf. Revenue Act of 1916, § 11; Revenue Act of 1918, § 231, and Revenue Act of 1921, § 231. See Sol. Op. 68, T. B. 41-20-1235.

CHAPTER 14

INCOME—IN GENERAL

The term "gross income" is defined by the law to include "gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." This definition of the term "gross income" contained in the 1918 law has not been changed in any respect by the Revenue Act of 1921.[1] The general rules and principles applicable to income from all sources will be discussed in this chapter, and thereafter the special rules applicable to income from (1) personal services, (2) business, trade or commerce, (3) sales or dealings in property, (4) interest, rent, and royalties, (5) dividends, (6) miscellaneous sources. The special rules relating to income from partnerships and fiduciaries are treated in the chapters on those respective subjects.[2]

What Constitutes Income. A discussion of the various conceptions of "income" would be interesting but out of place in a work of this character. "Income," like most other words, has different meanings, dependent upon the connection in which it is used and the result intended to be accomplished by its use.[3]

[1] Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a). The clause "all other gains and profits derived from any source whatever" contained in the Virginia Income Tax (Acts 1902-04, Chapter 148, as amended by Acts 1912, Chapter 279) has been held not to be limited by the rule of *ejusdem generis* to the specific kinds of income enumerated theretofore (Commonwealth v. Werth, 116 Va. 604, 82 S. E. 695.)

[2] See Chapters 8 and 6.

[3] Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904, L. R. A. 1917, F. 806. One interesting definition is that contained in Waring v. The Mayor, 60 Ga. 93, which is as follows: "The fact is, property is a tree; income is the fruit: labor is a tree; income the fruit: capital the tree; income, the fruit.

The subject of what constitutes income in the technical or true economic sense is one upon which few economists and courts agree. As used, however, in the Sixteenth Amendment and in the statutes enacted in pursuance thereof, the word must be held to have been used in its common, ordinary meaning, and not in its technical or true economic sense, for it is a familiar rule of construction that ordinary words used in constitutions and statutes must be given their usual and common significance, if such meaning harmonizes with the evident intent of the language employed and with the purpose to be accomplished.[4] In its ordinary and popular meaning "income" is the amount of actual wealth which comes to a person during a given period of time. At any single moment a person scarcely can be said to have income. The word in most, if not all, connections, involves time as an essential element in its measurement or definition. It thus is differentiated from capital or investment, which commonly means the amount of wealth which a person has on a fixed date. Income may be derived from capital invested or in use, from labor, from the exercise of skill, ingenuity, or sound judgment, or from a combination of any or all of these factors.[5] One of the most recent of its definitions and the one most commonly accepted by the courts, is "the gain derived from capital, from labor, or from both combined."[6] It would be difficult to give a comprehensive definition which can be treated as universal and final but the word's usual synonyms are "gain," "profit," "revenue." It is used in this sense also by writers upon taxation and economics.[7] An able English jurist has held in effect that annual income is either a conventional figure or a mere approximation. Income must be a thing sufficiently real to be capable of being taken out of a business by its owners without impairment of capital. The exact point at which an impairment of capital begins is one that cannot easily be determined with pre-

The fruit, if not consumed as fast as it ripens, will germinate from the seed which it encloses, and will produce other trees and grow into more property; but so long as it is fruit merely, and plucked to eat and consumed in the eating, it is no tree, and will produce itself no fruit."

4 Van Dyke v. City of Milwaukee, 159 Wis. 460, 146 N. W. 812, 150 N. W. 509.

5 Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904, L. R. A. 1917, F. 806.

6 Stratton's Independence v. Howbert, 231 U. S. 399; Doyle v. Mitchell Brothers, 247 U. S. 179; Eisner v. Macomber, 252 U. S. 189. In U. S. v. Oregon, Washington, etc. Co., 251 Fed. 211, the court held that the term is not limited to earnings from economic capital, i. e., wealth industrially employed in permanent form. See Eliasberg Bros. Mercantile Co. v. Grimes, 204 Ala. 492, 86 So. 56.

7 Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904, L. R. A. 1917, F. 806.

cision, and questions of doubt as between income and capital must be resolved in favor of capital. In a very real sense losses may be admitted, while profits must be proved. Capital once impaired is gone, but the admission of a loss not fully realized by a complete transaction results in nothing more serious than a postponement of profit to a subsequent period. The imposition of an income tax in effect compels a withdrawal of a portion of the income from the business, and the tax is imposed ratably upon all net income, so that if through an error in computation a stated figure of income includes any amount of capital the tax is imposed not upon income but upon capital.[8] One conception of income excludes gains or increment in the value of capital assets, but this conception was not that of Congress in enacting the recent income tax laws, since the tax is not only upon income conceived as production of capital but also upon gains and profits derived from sales or dealings in capital itself.[9] Property held by the taxpayer on March 1, 1913, the date of incidence of the first income tax law passed pursuant to authority given to Congress by the Sixteenth Amendment, is capital. Any liquidated claim existing unconditionally on March 1, 1913, and then assignable, whether presently payable or not and held by a taxpayer prior to March 1, 1913, whether evidenced by writing or not; and all interest which had accrued thereon before that date, do not constitute taxable income although actually recovered or received subsequent to such date.[10]

BOOKKEEPING ENTRIES. Real facts and not bookkeeping entries constitute income. Books of account are no more than evidential; they are neither indispensable nor conclusive.[11] A book value increase in the value of capital assets due to a reappraisal of property is not income within the meaning of the law.[12] A book entry reflecting only an enhanced value of assets during the year evidences an increase in the net worth of the corporation or individual for that year, an increase which, under adverse conditions, may disappear the next year. An increase in value thus evidenced is intangible, unstable and is not such income as the law contemplates shall be taxed.[13] Taxable income is that

[8] T. B. R. 48, T. B. 16-19-457.

[9] The constitutionality of taxing such gains and profits has recently been upheld by the Supreme Court of the United States. See Chapter 42.

[10] Reg. 45, Art. 87, as amended by T. D. 3206, T. B. 33-21-1767.

[11] Doyle v. Mitchell, 247 U. S. 179; Southern Pacific R. R. Co. v. Muenter, 260 Fed. 837.

[12] T. D. 2005; Baldwin Locomotive Works v. McCoach, 221 Fed. 59.

[13] Industrial Trust Co. v. Walsh, 222 Fed. 437; Letter from treasury department dated August 14, 1914; I. T. S. 1917, ¶ 260. See Reg. 45, Art. 23.

actually realized during the year, evidenced by the receipt of cash or its equivalent. Hence mere book entries of an appreciation in the value of capital assets will be disregarded.[14] Neither the government nor the taxpayer is bound by valuations entered on the books of the taxpayer.[15] This does not mean that the return of income should not be made in accordance with the taxpayer's books, for ordinarily the books reflect the real or actual facts. It means, for instance, that the government is not precluded from going behind the taxpayer's books and assessing the tax on the basis of the actual facts. Where property is carried at a nominal value on the books of the taxpayer, and the government seeks to assess a tax on the basis of that value, the taxpayer may prove, by other evidence, the true value of such property.[16] As a general rule, the method of accounting employed by a taxpayer determines his income. No system of bookkeeping or accounting is prescribed for all taxpayers, but the business transacted by the taxpayer should be so recorded that he may make a return of his true income and that each and every item set forth in the return of income may be readily verified by an examination of the books of account.[17] The books of a corporation are assumed to reflect facts as to its earnings, etc., hence they will be taken as the best guide in determining the net income, and, except as the same may be modified by provisions of the law wherein certain deductions are limited, the net income disclosed by the books and verified by the annual balance sheet, or the annual report to stockholders, should be the same as that returned for taxation.[18] It has been held that no taxable income

[14] Reg. 45, Art. 23; Fink v. N. W. Mutual Life Ins. Co., 267 Fed. 968; T. D. 3057, T. B. 36-23-1187; Letter from treasury department dated August 14, 1914; I. T. S. 1917, ¶ 260.

[15] Doyle v. Mitchell Brothers, 235 Fed. 686, affirmed 247 U. S. 179. In some instances the law places a further determining importance on the bookkeeping entries, as in the case of worthless debts. The latter seems to be the only deduction expressly required by the law to be evidenced by book entries in the case of individuals. Under the 1916 Law this was true also of cases of losses, which were required to be sustained and "charged off" in order to be deducted by corporations. (Revenue Act of 1916, § 12 (a).)

[16] U. S. v. Guggenheim Exploration Co., 238 Fed. 231. In this case the value at which the property was acquired, the declaration of the board of directors as to such value, at the time of acquisition, and statements in the annual reports, were held to overcome in weight the alleged admission against interest in placing the valuation of the property on the books at a nominal amount.

[17] Reg. 45, Art. 24; Reg. 33, Art. 182; T. D. 2161.

[18] Reg. 33, Art. 183.

accrues to a public utility corporation from a mere book entry charging construction account and crediting income account due to charging interest on the company's own funds used temporarily for construction purposes, as permitted under the classification of the interstate commerce commission.[19]

Income Actually Received. The courts have uniformly construed the word "income" to include only the receipt of actual cash as opposed to contemplated revenue due but unpaid, unless a contrary purpose is manifest from the language of the statute; that is, the courts in the absence of a clear direction to the contrary construe a revenue law in accord with an intention to reach actual and not potential income.[20] One cannot be said to reach

[19] O. D. 246, T. B. 13-19-425; O. D. 811, T. B. 7-21-1453. Neither will the company be allowed to include in its assets such amount of interest charged to capital account for the purpose of determining invested capital. The principles contained in the above ruling are applicable under the Revenue Acts of 1916 and 1917 (O. D. 1061, T. B. 41-21-1862).

[20] U. S. v. Schillinger, 14 Blatch. 71, 27 Fed. Cas. No. 16,228. The language of the 1909 Law, Act of August 5, 1909, § 38 (36 Stats. 112), was held to indicate that the net income, which was the measure of taxation, meant what had actually been received and not that which, although due, had not been received, its payment for any reason having been deferred or postponed. (Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918; Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206; Fink v. N. W. Mutual Life Ins. Co., 267 Fed. 968. See also Lumber Mut. Fire Ins. Co. v. Malley, 256 Fed. 380.) In Connecticut General Life Ins. Co. v. Eaton, 218 Fed. 188, it was held under that law that items of "non-ledger assets" shown in the annual report of a life insurance company, made in pursuance to a state statute as "uncollected and deferred premiums" and "interest due and accrued," but no part of which had been received, were not a part of the company's "income received during such year." Speaking of the 1909 Law, Justice Pitney said in Hays v. Gauley Mountain Coal Co., 247 U. S. 189: "The expression 'income received during such year' employed in the Act of 1909, looks to the time of realization rather than to the period of accruement." Accrued but unpaid interest on investments has been held not to be income. (Ins. Co. of North America v. McCoach, 218 Fed. 905.) In the 1913 Law the phrase "arising and accruing" was used. Doubtless it was the intention of Congress to employ terms of sufficient comprehension to reach actual income by foreclosing any possible avenue of escape, but it can hardly be said that in so doing an intention prevailed to tax that which did not actually exist, except on paper, as income accrued during the taxing period. (Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201, modified by the Supreme Court (251 U. S. 342) on another point.) An early ruling of the treasury department, under the 1913 Law, holding that a person receiving fees or emoluments for professional services must report all actual receipts for services rendered in the year for which the return was made, together with all unpaid accounts, charges for services or contingent income due for that year, was discussed in Edwards v. Keith, 231 Fed. 110, in which the court said: "No such construction of the treasury department

an income of defined proportions until he balances receipts and disbursements at the end of a stated period and ascertains, not what is due, but what has been actually received. The assets and liabilities may be measured by a different rule of accounting, but as said in one case,[21] "in the absence of any special law to the contrary, income must be taken to mean money, and not the expectation of receiving it or the right to receive it at a future time." Under the Revenue Act of 1918 all items of gross income were required to be reported in the year in which received by the taxpayer, unless in order clearly to reflect income such amounts were to be accounted for as of a different period.[22] The same is true under the 1921 Law.[23] The law intends, therefore, primarily to tax income received, and not income which has arisen or accrued, but has not been received.[24] This basis of actual receipts is not exclusively prescribed; for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. Net income is computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer unless no such method of accounting has been employed or the method employed does not clearly reflect the income, in which case the computation is made on such basis and in such manner as in the

can enlarge the scope of the statute so as to impose the tax upon unpaid charges for professional services rendered, which for aught any one can tell may never be paid. The statute alone determines what is income to be taxed. It taxes only income derived from many specified sources, and one does not derive income by rendering services and charging for them." In State ex rel. Moon Company v. Wisconsin Tax Commission, 166 Wis. 287, 163 N. W. 639, the court distinguishes between the case at bar and the case of Lynch v. Turrish, 247 U. S. 221, on the ground that the 1913 Federal Law taxed net income "*arising or accruing*" from all sources in the preceding calendar year, while the Wisconsin Law (§ 1087 (M) 1, Stat. 1911) taxed income *received*. The court said: "Unlike the federal act there is no need (under the Wisconsin Act) to ascertain whether the income arose or accrued in order to determine when it is taxable. The fact that it was received during 1911 makes it taxable irrespective of when it arose or accrued." In the 1916 Law the phrase "income received" was used with respect to both individuals and corporations. (Revenue Act of 1916, §§ 1 (a) and 10 (a).)

[21] Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201, 251 U. S. 342; T. D. 2451.

[22] Revenue Act of 1918, § 213 (a). Reg. 45, Art. 23. Stock dividends were an exception to this rule, but they have been held exempt (Eisner v. Macomber, 252 U. S. 189).

[23] Revenue Act of 1921, § 213 (a).

[24] Revenue Act of 1921, §§ 213 (a) and 233 (a); Revenue Act of 1918, §§ 213 (a) and 233 (a).

opinion of the commissioner does clearly reflect the income.[25] Thus, individuals and corporations may report their income upon the basis of accruals instead of actual receipts. In other words, under the Revenue Acts of 1918 and 1921, the time as of which any item of income is to be accounted for is to be determined in the light of the fundamental rule that the computation of net income shall clearly reflect the taxpayer's income.[26] Unless the taxpayer keeps his books on a basis other than that of actual receipts, and reports accordingly, he should report as income all amounts received in the year in which payment is actually made.[27] The rules under the preceding laws are applicable under the 1918 and 1921 Laws if the taypayer keeps his books on the basis of actual receipts.[28] Thus, dividends and interest, professional fees of lawyers, physicians, and the like, need not be returned as income in the year in which they become due or are earned, but should be returned as income in the year in which the payments are received or made available.[29] Where the service and payment period is divided by the end of the taxable year, the compensation for the period so divided at the end of the year will be accounted for as income for the year in which payment is actually received. Where the service is compensated by fee, or is of such nature that no part of the fee or compensation becomes due until the completion of the service, the entire amount received should be income to be accounted for as of the year of receipt.[30] It is immaterial that the services for which payment may be made have been performed for a period extending over several years, the entire payment is taxable in the year in which received, and may not be pro-rated.[31] A more extended discus-

[25] Revenue Act of 1921, §§ 212 (b) and 232; Revenue Act of 1918, §§ 212 (b) and 232.

[26] Reg. 45, Art. 22.

[27] Reg. 45, Art. 23.

[28] See one exception to this rule (Reg. 45, Art. 52).

[29] Letters from treasury department dated February 18, 1915, and March 1, 1915; I. T. S. 1919, ¶¶ 855 and 853.

[30] Reg. 33 Rev., Art. 4.

[31] Jackson v. Smietanka, 267 Fed. 932, affirmed 272 Fed. 970. T. D. 2135. In Edwards v. Keith, 231 Fed. 110, it was argued on behalf of an agent of a foreign insurance company, under a contract by the terms of which he should receive compensation on premiums of policies to the extent of certain specified percentages for a term aggregating twenty years from the date of each policy, that all of the labor creating such income had been performed prior to the incidence of the tax, but the court held that fact to be immaterial and sustained an assessment on the entire income for the year in which it was received. See also Holbrook v. Moore, U. S. Dist. Ct., E. Dist. Mo., decided February 8, 1921; Ct. D. 10, T. B. 17-21-1592.

sion of the subject of when items of income should be included in gross income will be found elsewhere in this book.[32]

Income Constructively Received. The rule that the law ordinarily taxes income "received" and not that which has "arisen or accrued" is subject to the qualification that income may be constructively as well as actually received. This is not in truth a qualification; it is a matter of defining the term "received." Income which is credited to the account of, or set apart for, a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession.[33] To constitute receipt in such a case the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. A book entry, if made, should indicate an absolute transfer from one account to another. If the income is not credited, but is set apart, such income must be unqualifiedly subject to the demand of the taxpayer. Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until the termination of five years of employment, the mere crediting on the books of the corporation does not constitute receipt. The distinction between receipt and accrual must be kept in mind. Income may accrue to the taxpayer and yet not be subject to his demand or capable of being drawn on or against by him.[34] Appreciation in the value of property is not even an accrual of income to the taxpayer prior to the realization of such appreciation through conversion of the property.

A corporation owning stock in four other companies decided to distribute its assets as a liquidating dividend, an option being given to the stockholders in the case of the stock of one of the companies, to take either stock or cash. The board of directors in December, 1915, authorized the distribution and at the same time authorized the mailing of a circular letter to the stockholders giving them until January, 1916, to elect whether to take stock or cash. This circular letter advised the stockholders that the distribution was "to be made as of December —, 1915."

[32] See Chapter 33.

[33] The 1921 Law is specific in this respect with regard to taxable distributions of corporations. (Revenue Act of 1921, § 213 (a).)

[34] Reg. 45, Art. 53, Reg. 33 Rev., Art 4; letter from treasury department dated May 31, 1919; I. T. S. 1921, ¶ 696. See Chapter 33 for a further discussion of this subject.

In the case of a stockholder making no election, it was assumed that he desired cash. The resolution provided that for the purpose of this distribution the transfer books of the company were to be closed December —, 1915, and reopened January —, 1916. The circular letter stated that the stock or cash would be distributed "as soon after January —, 1916, as practicable." The distribution was actually made in January, 1916. One of the stockholders participating in the distribution claimed that the amount distributed should be treated as constructively received in 1915. This claim was denied, it being held that while rights vested in the stockholders in 1915, they constituted a mere chose in action, a right to receive property at a future date. The theory of constructive receipt by its very nature does not apply to the receipt of an indefinite thing. There can be no receipt, constructive or otherwise, when the thing to be received is not yet determined. Until the exercise of their option by the stockholders and communication thereof to the corporation, no payment could be made under the terms of the resolution declaring the distribution. Election was a condition precedent to the right to demand payment.[35]

Examples of Constructive Receipt. Where interest coupons have matured, but have not been cashed, such interest payment, though not collected when due and payable, is nevertheless available to the taxpayer and should therefore be included in his gross income for the year during which the coupons matured. This is so if the coupons are exchanged for other property instead of eventually being cashed. Dividends on corporate stock are subject to tax when set apart for the stockholder and made unqualifiedly subject to his demand, although not yet collected by him.[36] The distributive share of the profits of a partner in a partnership or of a stockholder in a personal service corporation is regarded as received. Interest credited on savings bank deposits, even though the bank nominally have a rule, seldom or never enforced, that it may require so many days' notice in advance of cashing depositors' checks, is income to the depositor when credited.[37] Where under the by-laws of a co-operative bank the profits credited to a shareholder may not be withdrawn in their entirety until five years have elapsed, but three-fourths of such profits may be withdrawn at any time upon thirty days' notice, in which case the other fourth is forfeited it has been held that three-fourths of the profits credited to the shareholder

[35] A. R. R. 375, T. B. 15-21-1560.

[36] Reg. 45, Art. 54; Revenue Act of 1921, § 213 (a).

[37] Reg. 45, Art. 54.

are credited to or set apart for him without restriction, and as such should be included in gross income for the year in which so credited or set apart. The remaining one-fourth becomes income, constructively received, at the end of the five-year period, provided he has not previously withdrawn his shares.[38]

In 1891 A purchased an interest in a corporation and was elected treasurer. At the time of this purchase the company had large indebtedness, a small and inadequate plant, and comparatively little business. A placed behind the company all his personal credit, endorsing its notes and contracts freely, and after some years of effort on his part the business became one of the leading businesses of its kind and regularly paid dividends. In 1906 it was agreed that A should receive as his annual compensation, in lieu of salary, a commission upon the increase of business of the company under his management. It was arranged that he should be paid a weekly allowance and that any excess of his commission beyond such allowance should be credited to him monthly upon the books of the company, but not actually paid except at the convenience of the company. In 1916 his weekly drawings were in excess of his commissions for that year, while in 1917 and 1918 his commissions exceeded the amount of his actual drawings. In his return he included as income for those years the amounts actually withdrawn. It was held that the amounts credited during these years as distinguished from the amounts actually withdrawn constituted taxable income to A.[39]

Receipt by Agent Is Receipt by Principal. A system of accounting adopted by an insurance company, which allowed a period of two months to local agencies in which to report their cash premium receipts to the home office, has been held, in view of the rules and regulations of the commissioner, not to "clearly reflect" the company's income. A payment to the agent was held to be payment to the principal, and the company was required to include such payments in the return for the year in which they were received by the agent. The provision of the 1916 law, permitting a corporation to report according to its books, was held not to justify the system followed by the corporation in this case, as the system adopted was required to be such as to "clearly reflect its income,"[40] and the provision[41] of the law that if the method of accounting regularly employed does not clearly re-

[38] O. D. 1081, T. B. 44-21-1892.

[39] A. R. R. 366, T. B. 4-21-1404.

[40] Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201, modified by the Supreme Court on another point (251 U. S. 342).

[41] Revenue Act of 1921, § 212 (b); Revenue Act of 1918, § 212 (b).

flect the income, the computation of net income shall be made upon such basis and in such manner as in the opinion of the commissioner does "clearly reflect" income would seem to justify the same conclusion under the present law. The basis of this decision is undoubtedly that the cash premium receipts of the local agencies were constructively received by the home office when they were received by the local agencies. When the officers of a corporation upon the sale of their capital stock in the corporation to another corporation agree not to engage in a similar business for a certain period within the United States, any part of such consideration in fact payable to the other employees of the corporation for the purpose of securing their good will is not income to the officers even though the agreement of sale of the stock makes no mention of this collateral arrangement. It must, however, be satisfactorily established that by written or oral understanding such part of the consideration was not for the benefit of the officers.[42] Since an unrecorded assignment of an oil and gas lease under the laws of Oklahoma, executed in good faith and actually delivered, passes title, funds coming into the hands of the assignor thereafter are held by him in trust for the benefit of the assignee.[43]

Income Accrued. The Revenue Act of 1918 changed the privilege of reporting income upon the basis of book entries to a requirement that income be so reported. It is expressly provided that net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of a taxpayer; if no such method of accounting has been so employed or if the method employed does not clearly reflect income the computation is to be made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect the income.[44] Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. The method of accounting will not, however, be regarded as clearly reflecting income, unless all items of gross income and all deductions are treated with reasonable consistency. The two systems can not overlap; a taxpayer may not report in part on the accrual and in part on the basis of actual receipts.[45]

[42] A. R. M. 56, T. B. 23-20-984.

[43] Sol. Op. 59, T. B. 38-20-1201.

[44] Revenue Act of 1918, § 212 (b); Revenue Act of 1921, § 212 (b); Reg. 45, Art. 22. See Chapter 33 for a full discussion of this subject.

[45] Reg. 45, Art. 23; Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201. This case was modified by the Supreme Court (251 U. S. 342) but the principle here involved was upheld.

Income Received in Kind. When income is received in kind, as for instance, in produce, crops, or other property having no definite market value, no tax is assessable until the produce, crops or other property is disposed of, in which year such income is first reduced to money or a money equivalent.[46]

Income Received in the Equivalent of Cash. Items of income, as well as expenditures, need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation of net income, can be readily valued in terms of money.[47] The Revenue Act of 1918 expressly provided that

[46] Revenue Act of 1921, § 202 (c); Revenue Act of 1918, § 202 (b); T. D. 2153.

[47] Id. Reg. 45, Art. 22. It is held by the treasury department in a variety of cases that income (other than from dividends and from personal services) may be received in a form other than cash. Thus, where farm produce is exchanged for merchandise, groceries or mill products, the market value of the article or product received in exchange is to be returned as income. (Reg. 45, Art. 38). *Rents* received in crop shares should be returned as income of the year in which the crop shares are reduced to money or a money equivalent. (Reg. 45, Art. 38). When improvements made by a lessee become part of the real estate, the value of such improvements to the extent of their fair market value is income to the lessor at the time such improvements are made (Reg. 45, Art. 48, as amended by T. D. 3206, T. B. 33-21-1767). Warrants received by contractors pursuant to state contracts are considered income. (Reg. 45, Art. 37). Promissory notes are held to be income to the extent of their discount or fair market value. (Reg. 45, Art. 34; letter from treasury department dated March 1, 1915). As stated broadly in Article 21 of Regulations 45, the term income "is not limited to cash alone, for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion and accounts payable for expenses incurred." Again in Regulations 45, Art. 31, it is stated that "income may be received in the form of cash or of property." The case of Peabody v. Eisner, 247 U. S. 347, which recognized the doctrine that dividends received in the form of property (stock of corporations other than the distributing corporation) were taxable under the 1913 Law, which did not contain any express provision that "property" dividends should be taxable, settles the point that taxable income may be received in the form of *property*. (See also U. S. v. Phellis, 42 Sup. Ct. Rep. 63; Rockefeller v. U. S., N. Y. Trust Co. v. Edwards, 42 Sup. Ct. Rep. 68. The question still remains, however, how far the statute reaches out to tax "property" income; in other words, what is to be considered the "equivalent of cash." For purposes of "property" income, a line must be drawn somewhere between such readily convertible property as Liberty bonds and such extremely unconvertible property, as, for example, works of art. The question occurs in each case: Can the property received be turned to pecuniary account? The provision of the Revenue Act of 1921 (§ 202 (c)) that when property is exchanged for other property no gain or loss shall be recognized unless the property received in exchange has a *readily realizable* market value is an indication that Congress had in mind the difficulties inherent in such transactions and marks a step in ad-

amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.[48] It also expressly provided that "property" dividends should be taxable.[49] The Revenue Act of 1921 provides that any distribution (whether in cash or other property) made by a corporation to its shareholders or members otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the cost for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee.[50] Inventories and accounts receivable may also be income-producing factors.[51] Salaries, wages or compensation for personal services of whatever kind "and in whatever form paid" are taxable income.[52] Under the 1918 Law any property having a market value was the equivalent of cash when received in exchange for other property.[53] Under the present law, on an exchange of property, no gain or loss is recognized unless the property received in exchange has a *readily realizable* market value.[54] A dealer in automobiles who takes used machines as part payment on sales of new cars is required to report the entire profits real-

vance of all past legislation on this subject. Even now, each case will have to be decided upon its peculiar facts and the character of the property received. It is not easy to determine whether property has a readily realizable market value; the definition of this term involves much of the same difficulty which was involved in the term "fair market value, if any", and it is well to guard against the impression that the present law has finally solved the problem of what is and what is not property income. (Tennant v. Smith, (1892) A. C. 150, 66 L. T. 327, 3 Tax Cas. 158; U. S. v. Schillinger, 14 Blatch. 71, 27 Fed. Cas. No. 16,228; U. S. v. Smith, 27 Fed. Cas. No. 16,341; State v. Frear, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164.) This subject is more fully discussed in Chapter 17.

[48] Revenue Act of 1918, § 201 (c). This section also provided that stock dividends should be considered income to the amount of earnings or profits distributed but stock dividends were held not to be taxable. See Chapter 19.

[49] Revenue Act of 1918, § 201 (a).

[50] Revenue Act of 1921, § 201 (c).

[51] Revenue Act of 1921, §§ 202 (a) and 203; Revenue Act of 1918, §§ 202 (a) and 203; Reg. 45, Art. 21.

[52] Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a).

[53] Revenue Act of 1918, § 202.

[54] Revenue Act of 1921, § 202 (c). Even where the property received has a readily realizable market value no gain or loss is recognized in certain cases specified by the statute. (Revenue Act of 1921, § 202 (c).) This subject is fully treated in Chapter 17.

ized on the new cars for the year in which received regardless of the fact that part of the payments received are in the form of used machines. The fair market value of the used cars taken as part payment is deemed to be the value at which they were taken in on the sales.[55]

Income Received in the Form of Notes. Payments received in the form of promissory notes, not merely security for such payments, constitute income to the amount of their readily realizable market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, may properly treat as income as of the time of receipt the fair discounted value of the note at such time. Thus, if it appears that such a note is or could be discounted on a six or seven per cent. basis, the recipient may include such note in his gross income to the amount of its face value less discount computed at the prevailing rate of such transactions. If the payments due on a note so accounted for are met as they become due, there should be included as income in respect of each such payment so much thereof as represents recovery for the discount originally deducted.[56] If notes can not be so discounted or are not readily marketable, they need not be reported as income until paid. Thus, when a corporation keeping its accounts on the basis of actual receipts and disbursements, loans money secured by first mortgage bonds and receives as commission second mortgages on the property of the borrower payable without interest in 5 or 10 annual installments, such second mortgage notes were held under the 1918 Law to be income at their fair discounted value as of the date of receipt. They had a dis-

[55] O. D. 782, T. B. 5-21-1413.

[56] Reg. 45, Art. 34. This regulation used the term "fair market value", as required by the 1918 Law. With the substitution of the words "readily realizable" for the word "fair" it would seem to state the present law. In U. S. v. Schillinger, 14 Blatch. 71, 27 Fed. Cas. No. 16, 228, arising under the Civil War Income Tax Laws, it was held that promissory notes taken in payment of a patent right were not income until the notes became due. The court said: "In this case the defendant changes his patent rights for promissory notes payable in the future. Their value was uncertain; they might or might not be paid; but, until they were paid, they were not income, but only the ground of expecting income. The notes were no more taxable as income than would have been other patent rights, if the defendant had received them in payment of those he sold." On the other hand, in U. S. v. Smith, 27 Fed. Cas. No. 16,341, also arising under the Civil War Income Tax Laws, it was held that a transfer of stocks for a promissory note, which is collectible, or an exchange thereof for land, followed by a sale of such land within the year, for collectible promissory notes, is to be considered a sale of such stock for so much cash.

count or market value at that time. If the notes were not marketable at a fair discount, each installment payment was held to be gross income in its entirety in the year in which received.[57] A taxpayer in computing his net income will not be obliged or allowed to value his notes receivable at their fair market value in cases where the time for the payment of such notes has been extended by the taxpayer and the notes can not be discounted or sold without material loss. If this were not the case, a merchant who had notes receivable for goods sold and who granted the purchaser an extension of time within which to pay the notes would be permitted to treat the fair market value of the notes as the price for which the goods were sold or to deduct from gross income as a loss the difference between the face value of the notes and their fair market value at the time they originally became due. The effect of such a procedure would be to allow taxpayers to take a deduction for bad debts prior to the year in which they were determined worthless and charged off contrary to the plain wording of the statute.[58]

Gross Receipts and Gross Income. It is important to note that the term "gross receipts" as ordinarily used is not synonymous with the term "gross income" for tax purposes. A taxpayer's gross income consists of his gross receipts less (a) receipts fundamentally free from tax, such as receipts constituting a return of capital, and (b) receipts representing the kind of income specifically exempted by the law.[59] The Revenue Act of 1918 was the first income tax law to use the term "gross income," defining what is and what is not included therein, the latter being exempt income.[60]

Exempt Income. In addition to receipts fundamentally free from tax (such as a return of capital) the present law, as well as the Revenue Act of 1918, specifically prescribe that certain receipts shall not be included in gross income and shall be

[57] O. D. 728, T. B. 46-20-1302.

[58] O. D. 979, T. B. 30-21-1742. But see the new provision in the 1921 Law for the deduction of a proportionate amount of worthless debts, discussed in Chapter 25.

[59] Reg. 45, Arts. 21, 71.

[60] Revenue Act of 1918, §§ 213 and 235; Revenue Act of 1921, §§ 213 and 235. Prior to the enactment of the Revenue Act of 1918 the treasury regulations and rulings referred to "gross income" generally as the income of the taxpayer before making the deductions and allowances permitted by law. The 1916 Law did not use the phrase "gross income," but in prescribing the deductions allowed to corporations made use of the phrase "gross amount" of its income. (Revenue Act of 1916, § 12 (a).)

exempt from the tax.[61] The exemption of these receipts depends in certain instances on the status or character of the recipient, and in other instances there is no such limitation, the exemption being applicable whether the recipient is an individual or a corporation. The classes so exempted by the present law are given below; unless otherwise stated the same exemption was allowed under the 1918 Law:

(1) The proceeds of life insurance policies paid upon the death of the insured;[62]

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property must be included in gross income);

(4) Interest upon (a) the obligations of a state, territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest is exempt only if and to the extent provided in the respective acts authorizing the issue thereof, as amended and supplemented, and may be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes;[63]

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest

[61] Revenue Act of 1921, §§ 213 (b), 233 (a); Revenue Act of 1918, §§ 213 (b), 233 (a).

[62] Under the 1918 Law only the proceeds of such policies paid to *individual* beneficiaries or to the estate of the insured were exempt. The treasury department ruled that the term "industrial beneficiaries" includes partnerships (T. B. R. 32, T. B. 16-19-270; letter from treasury department dated November 18, 1919; I. T. S. 1921, ¶ 1208).

[63] Under the 1918 Law interest credited to postal savings accounts upon money deposited subsequent to September 1, 1917, was taxable. (Reg. 45, Art. 77).

on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other sources within the United States;

(6) Amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any state, territory, or the District of Columbia, or any political subdivision of a state or territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof, as is more fully indicated elsewhere in this book.[64]

(8) The income of a nonresident alien or foreign corporation which consists exclusively of earnings derived from the operation of a ship or ships, documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States;[65]

(9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war;[66]

(10) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300;[67]

(11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation;[68]

(12) The receipts of shipowners' mutual protection and indemnity associations, not organized for profit, and no part of the net earnings of which inures to the benefit of any private

[64] See p. 357.

[65] This exemption was not contained in the 1918 Law.

[66] This exemption was not contained in the 1918 Law. See Chapter 12 for a discussion of the purpose of this exemption. It takes the place of the exemption granted by the 1918 Law of so much of the amount received during the recent war by a person in the military or naval forces of the United States for active service in such forces, as did not exceed $3,500.

[67] This exemption was not granted by the 1918 Law.

[68] This exemption was not granted by the 1918 Law.

stockholder or member, but such corporations shall be subject as other persons to the tax upon their net income from interest, dividends, and rents.[69]

FEDERAL RESERVE BANKS. The income of federal reserve banks is exempt from income tax[70] by express provision in the Federal Reserve Act.[71] The dividends on the stock of such banks are exempt from tax in the hands of member banks.[72] Dividends paid by member banks are treated like dividends of ordinary corporations and are not exempt from tax.[73]

Net Income. "Net income" is defined by the Revenue Acts of 1918 and 1921 to be gross income as defined by the law less the statutory deductions.[74] Thus, taxable net income is wholly a statutory conception, although it follows, subject to certain modifications as to exemptions and as to some of the deductions, the lines of commercial usage. Statutory net income is, subject to these modifications, commercial "net income." This appears from the fact that ordinarily it is to be computed in accordance with the method regularly employed in keeping the books of a taxpayer.[75] Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year.[76]

Net Income Subject to Normal Tax. The entire net income, as defined in the preceding paragraph, is subject to the surtax in the case of individuals and the excess-profits tax in the case of corporations. For the purpose of the normal tax in the case of individuals and the income tax in the case of corporations, certain additional deductions called "credits" are allowed.[77] These credits in the case of individuals are, (a) amounts received as dividends from domestic corporations (with certain exceptions specified by the statute) and from certain foreign corporations; (b) the amount received as interest upon obligations of the United States and bonds issued by the war finance corporation, which is included in gross income; (c) the personal

[69] This exemption was not granted by the 1918 Law.

[70] Also from the excess-profits tax.

[71] Federal Reserve Act, 38 Stat. 251, Ch. 6, § 7.

[72] Reg. 45, Art. 75. Federal Reserve Bulletin, April 1, 1916.

[73] Reg. 45, Art. 75, Reg. 33 Rev., Art. 86.

[74] Revenue Act of 1921, §§ 212 (a) and 232; Revenue Act of 1918, §§ 212 (a) and 232; Reg. 45, Art. 21.

[75] Reg. 45, Art. 21.

[76] Reg. 45, Art. 22.

[77] Reg. 45, Art. 21.

exemption; (d) the credit for dependents.[78] In the case of corporations the credits allowed are, (a) the amount received as interest upon obligations of the United States and bonds issued by the war finance corporation, which is included in gross income; (b) the amount of any war-profits and excess-profits taxes imposed for the same taxable year; (c) in the case of a domestic corporation, $2,000.[79] This specific credit of $2,000 is allowed under the present law only to corporations with net incomes of less than $25,000.[80]

Income of States and Political Subdivisions Thereof. In general, income accruing to any state, territory or possession of the United States, or to any political subdivision thereof, is exempt from tax.[81] Both the Revenue Act of 1918 and the Revenue Act of 1921 exempt the income derived from any public utility, or the exercise of any essential governmental function and accruing to any state, territory or the District of Columbia, or any political subdivision of a state or territory or income accruing to the government of any possession of the United States, or any political subdivision thereof. In addition to the above, both acts provide that whenever any state, territory, or the District of Columbia, or any political subdivision of a state or territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no income tax shall be levied upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such state, territory, District of Columbia, or political subdivision; but this provision is not intended and will not be construed to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in the law upon the part or portion of such income to which such person is entitled under such contract.[82] Rentals derived from the leasing of a railroad con-

[78] Revenue Act of 1921, § 216; Revenue Act of 1918, § 216. Such dividends are a deduction in the case of corporations. (Revenue Act of 1921, § 234 (a) (6); Revenue Act of 1918, § 234 (a) (6).

[79] Revenue Act of 1921, § 236; Revenue Act of 1918, § 236.

[80] Revenue Act of 1921, § 236 (b). See Chapter 10.

[81] Reg. 45, Art. 84; Cooley on Taxation, Vol. I., p. 153; Ward v. Maryland, 12 Wall. 418; Collector v. Day, 11 Wall. 113; U. S. v. Railroad Co., 17 Wall 322; S. 1374, T. B. 18-20-896. See the discussion of this subject in the paragraph "Interest on the Obligations of States" in Chapter 18. See also the discussion of this subject in Chapter 15.

[82] Revenue Act of 1921, § 213 (b); Revenue Act of 1918, § 213 (b).

structed and owned in common by certain townships and a county are income derived from a public utility and are exempt from income tax. The leased railroad must, however, file a return of income.[83] When a corporation is organized to furnish water, light, power and heat to a town, the town owning practically all the common stock, which is not dividend bearing, the preferred stock to be redeemed as soon as possible out of earnings, after which the plant becomes the property of the town, the income of the corporation from the operation of its plant is exempt from income tax, since the imposition of a tax would delay the redemption of the preferred stock, thereby imposing "a loss or burden" on the town. The corporation must, however, file a return of income.[84] The income of state workmen's compensation insurance funds established by state statutes is not taxable.[85] The funds contemplated are only those managed and controlled directly by the state through state officers, that is to say, those funds the management and control of which constitute an activity of the state. A mutual liability insurance company created by an act of the state legislature to provide insurance for employers to cover their liability under the state employers' liability act and workmen's compensation law, which is not so managed and controlled, is not exempt.[86] Where property is willed to a municipality in trust that the income of the property shall be used for a public charity the income is not liable to tax and the trustees of the fund are not required to file annual returns.[87] This is true even where the income is to be paid to an individual during his life.[88]

Income from Foreign Countries. Where income has accrued in a foreign country on foreign investments, but has not been remitted to the owner in this country, being placed to his credit in the foreign country, it has nevertheless been constructively received by the owner and he should report the same as income for the year in which it is placed to his credit, computing the amount in United States money by using the rate of exchange prevailing at the time the amounts were credited to him abroad.[89] Where a citizen of the United States purchases German securities in Germany, the interest being collected by a German bank,

[83] O. D. 250, T. B. 14-19-434.

[84] O. D. 328, T. B. 28-19-612.

[85] Reg. 45, Art. 84.

[86] O. D. 1074, T. B. 43-21-1883.

[87] O. D. 895, T. B. 14-19-433.

[88] O. D. 972, T. B. 28-21-1724.

[89] O. D. 419, T. B. 13-20-805. Letter from treasury department dated

January 11, 1916; I. T. S. 1921, ¶ 792. The following rates have been accepted as the current or market rates of exchange prevailing as of December 31, 1920:

London	3.535	(dollars to £ sterling).
Australia	3.55	(dollars to £ sterling).
New Zealand	3.55	(dollars to £ sterling).
Paris	.0595	(cents to franc).
Belgium	.0622	(cents to franc).
Milan	.0347	(cents to lira).
Zurich	.1528	(cents to franc).
Madrid	.1355	(cents to peseta).
Stockholm	.20	(cents to krone).
Christiania	.1535	(cents to krone .
Copenhagen	.1535	(cents to krone).
Amsterdam	.3145	(cents to guilder).
Buenos Aires	.7510	(cents to peso); .33375=1 paper peso).
Montevideo	.7462	(cents to centavo).
Colombia:		
Bogota	.8620	(Colombian cents to dollars).
Barranquilla	.8474	(Colombian cents to dollars).
Cartagena	.8474	(Colombian cents to dollars).
Medellin	.8474	(Colombian cents to dollars).
Lima	4.42	(dollars to Peruvian £).
Bolivia	.277	(cents to bolivianos).
Mexico City	.4925	(cents to pesa).
Yokohama	.48	(cents to yen).
Calcutta	.265	(cents to rupee).
Singapore	.42	(cents to Singapore dollars).
Dutch E. Indies	.3145	(cents to florin).
Germany	.01365	(cents to mark).
Poland	.0016	(cents to mark).
Austria	.0024	(cents to krone).
Czecho-Slovakia	.0115	(cents to krone).
Jugo-Slavia	.007	(cents to krone).
Greece	.074	(cents to drachma).
Roumania	.0126	(cents to leu).
Bulgaria	.0115	(cents to lev).
Serbia	.0274	(cents to dinar).
Finland	.032	(cents to markka).
Canada	.86	(cents to Canadian dollar).
Shanghai, China	.7725	(cents to tael).
Rio de Janeiro, Brazil	.1333	(cents to government paper milreis).
Manila, P. I.	.46	(cents to peso).

(O. D. 803, T. B. 7-21-1444; O. D. 898, T. B. 18-21-1605; O. D. 876, T. B. 16-21-1575; O. D. 913, T. B. 20-21-1632; O. D. 1027, T. B. 37-21-1811. For the rates prevailing as of December 31, 1919, see O. D. 551, T. B. 25-20-1010; O. D. 772, T. B. 2-21-1386; O. D. 1027, T. B. 37-21-1811, and O. D. 1036, T. B. 38-21-1826. For rates as of December 31, 1916, December 31, 1917, and December 31, 1918, see O. D. 1065, T. B. 42-21-1869; O. D. 1027, T. B. 37-21-1811; O. D. 1036, T. B. 38-21-1826.

and, after tax at the rate of 10% has been paid to the German government, the balance of the interest is credited to the account of the citizen, the income in question is taxable in the hands of the citizen. The interest should be converted into United States money values at the rate of exchange prevailing at the time the interest is credited to the citizen's account by the German bank. In the event the interest is not deposited, but is paid by check or draft drawn by the German bank in German marks, the interest should be converted into United States money values at the rate of exchange prevailing at the time the check or draft is received.[90]

Gains or Losses Relating to Foreign Dealings. If the owner mentioned in the previous paragraph receives a greater or less amount when the income is actually transmitted to him, owing to a fluctuation in exchange rates between the time when the income has been constructively received and the time when it is actually transmitted, it would seem that he should report the difference as income or claim it as a loss, as the case may be. Where in 1917 a domestic corporation purchased tangible property in a foreign country for a stated sum in the currency of that country at an exchange rate of $0.20, and later in the same year the property was transferred to a newly organized corporation of the same foreign country in exchange for its capital stock of a total par value equal to the same amount as the cost of the tangible property, the rate of exchange at the time of the transfer being $0.30, it was held that gain or loss was realized by the domestic corporation through the exchange of the property for stock of the new foreign corporation in the amount that the fair market value of such stock in American money at the time of such exchange was greater or less than the cost of the property in American money.[91] It has been held that no deductible loss was sustained where a corporation at the time of closing its books for the taxable year had an asset of pounds sterling represented by advances made in cash to its London representative for the purchase of raw material in the London market, the purchases not having been made at the time of the closing of the books by reason of the fact that the rate of exchange at the time of closing the books was lower than at the date the exchange was purchased.[92] Where shares of German securities were bought in Germany at 300,000 marks, or $9,000,

[90] O. D. 809, T. B. 7-21-1450.
[91] O. D. 938, T. B. 23-21-1670.
[92] O. D. 940, T. B. 23-21-1672.

and sold for 500,000 marks, or $5,000, the taxpayer may deduct a loss of $4,000.[93]

TAXPAYERS MANUFACTURING OR TRADING IN FOREIGN COUNTRIES. The rulings on the subject of computing the income of taxpayers trading or manufacturing in foreign countries are in some confusion. In the case of such taxpayers the committee has held that under the abnormal conditions characterizing foreign exchange during the European war, current assets less current liabilities payable in the foreign currency may be converted at the current rate of exchange or at any rate less favorable to the taxpayer. The commissioner will consider applications to adopt a rate more favorable to the taxpayer or may on his own motion apply such a rate where the facts in the particular case warrant such departure. This ruling has no reference to isolated or collateral investments in foreign credits or securities.[94] A domestic corporation which bought its raw material from foreign stockholders, making credit and debit entries first in francs and then in dollars at the rate of exchange prevailing at the date of each transaction, which corporation on closing its books converted the entire balance due into dollars at the rate as of the closing of the taxable year, has been held to have incorrectly reported income, since the method used resulted in the returning of unrealized gain or loss due to changes in the rate of exchange—a gain or loss which could never be realized (except upon liquidation) until the debit due the foreign interests was repaid. It was held that in order to reflect true net income, all amounts either debited or credited to the account of the foreign interests should be entered on the books in dollars at the rate of exchange prevailing at the date of the transaction; that any net debit at the end of a taxable year should be applied to the portion of the debt to the foreign interest longest outstanding; that any gain or loss arising from the difference in the rate of exchange prevailing at the time the obligation was incurred and the rate prevailing at the time the obligation is retired should be accounted for, the rate prevailing at the time the obligation is retired to be the average rate of exchange per dollar as ascertained by applying to each debit item against the foreign interests during such succeeding year the rate of exchange prevailing at the time each such debit item was created. The franc value might thereafter be

93 O. D. 809, T. B. 7-21-1450.

94 A. R. R. 15, T. B. 3-20-682.

disregarded.[95] The net profits of a foreign branch of a domestic corporation, which keeps a separate set of books in foreign currency and renders a report at the end of the year as to the profits, and which remits amounts to the home office from time to time when it has more money on hand than it needs, should be computed in foreign currency. From the total profits for the year should be subtracted the total amount remitted to the home office during the year, all expressed in foreign currency. To determine the equivalent of the profits in terms of United States money, the amounts remitted should be converted at the rate of exchange in effect at the date such remittances were made. The balance of the net profits, expressed in foreign currency, should be converted at the rate as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to the home office.[96] A taxpayer purchasing goods from a foreign country, the value of such goods being quoted in terms of the foreign currency, should enter the cost thereof at the current or market rate of exchange prevailing at the time payment for the goods is actually made.[97]

DEALER IN FOREIGN EXCHANGE. A dealer in foreign exchange —that is, one who regularly engages in the purchase and resale to customers of foreign money with a view to the gains and profits that may be derived therefrom—who, in his books of account regularly inventories unconverted foreign money on hand either (a) at cost or (b) at cost or market value whichever is lower, may make his return upon the basis upon which his accounts are kept. A taxpayer who is not a dealer in foreign exchange, but merely purchases foreign money on his own ac-

[95] O. D. 590, T. B. 29-20-1069. This ruling criticises the method employed by the company as productive of artificial and unrealized gain or loss arising from changes in the rate of exchange, yet the method proposed seems open to the same criticism. The ruling ignores the well established accounting practice that current assets and liabilities should be converted at the rate of exchange current on the date of the balance sheet. (See Kester—"Accounting Theory and Practice"—1918, Vol. II, page 547; Dickinson—"Accounting Practice and Procedure," pages 125-6; Dawson—"The Accountant's 'Compendium' ", pages 529-530; Cutworth—"Treatment of Fluctuating Currency in Accounts", page 10).

[96] O. D. 550, T. B. 25-20-1009; O. D. 489, T. B. 19-20-909; O. D. 618, T. B. 31-20-1109. This ruling leaves unsettled the question of gain or loss arising from a difference, if any, between the rate of exchange at the end of the year and the date or dates when the balance at the end of the year is remitted.

[97] O. D. 489, T. B. 19-20-909.

count or as an incident of his principal business may not inventory such unconverted foreign money at the close of his taxable year. The realization of the gain or loss is postponed until the foreign money is disposed of or converted.[98]

[98] O. D. 834, T. B. 10-21-1491.

CHAPTER 15

INCOME FROM PERSONAL SERVICES

The law expressly provides that the gross income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and in *whatever form* paid, or from professions or vocations. The provisions of the 1921 Law and the 1918 Law are identical in this connection.[1] It is to be noted that salaries, wages, or compensation for personal services are taxable income "in whatever form paid." Where services are paid for in something other than money, the fair market value of the thing taken in payment is income.[2] This is one of the three cases in which the law expressly specifies that the tax shall be based upon payments other than in cash, the others being the provision relating to dividends[3] and the provision relating to exchanges of property.[4]

Salaries. Salaries and compensation for services are ordinarily income of the year in which they are actually received rather than the year in which earned.[5] They will be income of the year in which actually earned, if the recipient keeps his accounts upon an accrued basis and reports accordingly. A salary paid by a corporation which is itself exempt is nevertheless subject to tax in the hands of the employee.[6] In the case of corporations, so-called "salaries" of stockholders, if they are unreasonable in amount and if they bear a close relationship to the amount of stock held, are treated as a distribution of the net profits of the corporation, are not deduct-

[1] Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a). It is to be noted that the Revenue Act of 1921, in the provision relating to exchanges of property, treats as the equivalent of cash only property with a *readily realizable* market value (§ 202 (c)). While the provision, stated in the text above, that amounts received as compensation for personal services shall be included as income in "whatever form paid" (§ 213 (a)) § 202 (c) is indicative of the more liberal intent of Congress in this respect in enacting the 1921 Law.

[2] Reg. 45, Art 33.

[3] Revenue Act of 1921, § 201; Revenue Act of 1918, § 201.

[4] Revenue Act of 1921, § 202 (c); Revenue Act of 1918, § 202 (b).

[5] T. D. 2135; T. D. 2090; A. R. R. 182, T. B. 29-20-1070; O. D. 717, T. B. 45-20-1289; O. D. 432, T. B. 14-20-824; O. D. 19, T. B. 1-19-31; O. D. 512, T. B. 21-20-948; O. D. 997, T. B. 34-21-1776. See Chapter 33.

[6] T. D. 2135; T. D. 2090.

ible as a business expense of the corporation, and are, therefore, not subject to the normal tax in the hands of the recipient.[7] So-called salaries representing an appropriation of assets of the corporation by officers who control it and fix their compensation in violation of the rights of the corporation are not deductible by the corporation insofar as they exceed a reasonable amount; such excessive payments are to be treated by their recipients, however, as compensation subject to the normal tax, since compensation illegally secured is none the less subject to tax in all respects.[8] So-called salaries constituting in part payment for property, should, insofar as they exceed a reasonable amount, be treated by the corporation as a capital expenditure and by the recipient as part of the purchase price. In the case of excessive payments by individuals or partnerships, the amounts of ostensible salaries disallowed as deductions should ordinarily be treated as shares of the profits of a partnership, except that salaries constituting in part payment for property should be treated by the paying individual or partnership as a capital expenditure and by the recipient as part of the purchase price.[9]

Bonuses and Profit Sharing. Where employees receive bonuses, or are entitled to a share of the profits of the employer the amount so received should be included as income, provided (a) it is clearly made as compensation for services rendered and (b) it is paid under a contract, express or implied, or a long-time practice (practically an implied contract) regularly employed, which constitutes a condition, if not a contract, under which the employees may reasonably expect additional pay for the greater or better services which they render, or (c) the total amount of salary and bonus is not greater than a reasonable compensation for the services rendered by the employee.[10] Such payments are income to the employee if they are of such character that the employer is entitled to deduct them as an expense of doing business. If a bonus is a mere gift, the employee should not treat it as income, since gifts or gratuities are not taxable, and the employer is not entitled to deduct it from his income as an expense of doing business. The rules governing the deduction of bonuses and profit sharing payments are more fully treated

7 Except in the case of certain corporations specified in § 216 (a) of the Revenue Act of 1921, the dividends of which are not allowed as a credit against the normal tax.

8 See, however, Rau v. U. S., 260 Fed. 131, 136, wherein it is stated that embezzled moneys are not income.

9 Reg. 45, Art. 106; T. D. 2696. See Chapter 22.

10 Reg. 45, Art. 107; T. B. 2696. See Chapter 22.

elsewhere in this book.[11] The rule to be followed by the employee is that if the employer is entitled to deduct the payments in question as an expense of doing business, the employee should return them as income; while if the employer is not entitled to deduct the payments in question as an expense, the employee should not return them as income, otherwise the same item of income would be taxed twice. If so-called bonuses or shares of profits paid to officers or stockholders of corporations, are in fact distributions of net profits bearing a close relationship to stock holding, or a waste or appropriation of the corporation's assets, or in part payment for property, they will be treated as indicated in the preceding paragraph. The same considerations apply when excessive bonuses are paid by individuals or partnerships.[12] When extra compensation in the form of bonuses, or otherwise, is paid to employees by affording them an opportunity to purchase stock of a corporation and title to the stock remains in the corporation until it is fully paid for, any so-called dividends credited to the employee purchasing the stock as part payment are not in fact dividends, since dividends cannot legally be declared on unissued or treasury stock. Such dividends constitute additional compensation to the employees. Where special allowances are credited to the account of such employee as part payment upon the fulfillment of certain conditions, provision being made for the payment of a certain amount if the employee does not default, such special allowances are held to constitute additional compensation. But neither the so-called dividends or such special allowances constitute income until the terms of the agreement have been completed.[13]

Any lump sum received by an employee from a former employer upon the termination of his employment has in it a large element of compensation for services previously rendered and must be returned as income for the year in which it was received.[14]

Commissions. Commissions paid salesmen, compensation for

[11] See Chapter 22.

[12] Reg. 45, Art. 106; T. D. 2696.

[13] See Chapter 33 for the reason for this rule. O. D. 763, T. B. 1-21-1370. The same rule was applied in a case with similar facts and where, in addition, in case of resignation or discharge of an employee prior to the time of receiving title to the stock, he was to receive the dividends paid to the trustee on account of the stock issued in his name, and in case of his death they were to be paid to his next of kin. (O. D. 791, T. B. 6-21-1426).

[14] O. D. 1029, T. B. 37-21-1814.

services on the basis of a percentage of profits, and commissions on insurance premiums are income to the recipients.[15]

Traveling Expenses. The Revenue Act of 1921 provides that "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business"[16] may be deducted. This provision was not contained in the 1918 Law and under that law the department made many and conflicting regulations and rulings as to the deductibility of, or income from, traveling expenses. The latest rulings under the 1918 Law (which seem to be too complicated to be practicable) insofar as they relate to income are as follows: If an individual receives a salary and is also repaid his actual traveling expenses, he is required to include in gross income an amount thereof equal to the ordinary expenditures required for meals and lodging when at home, as such amount is held to be additional compensation to the taxpayer. If he receives a salary and also an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, any excess of the cost of such meals and lodging over the sum of the allowance and the ordinary expenditures required for such purposes when at home, is deductible, but any excess of the allowance over the difference between such expenses and such ordinary expenditures is taxable income. Congressmen and others who receive a mileage allowance for railroad fares should return as income any excess of such allowance over their actual expenses for such fares.[17]

Insurance Premiums Paid for Employees. Premiums paid by an employer on life, accident or health policies in favor of his employees as additional compensation of such employees have been held to be income to the employees.[18] Premiums paid by an employer on policies of group life insurance covering the lives of employees, the beneficiaries of which are not designated by the employees, are not income to such employees. The financial benefits under such policies do not move to the employees personally but only to their heirs or dependents after their deaths, and the payment of the policies is in any case contingent upon the employee's continuance until death in the employment of his present employer, which employment may be terminated at any time by himself or his employer. The payment is also contin-

[15] Reg. 45, Art. 32; S. 1312, T. B. 7-20-738; T. D. 2090; letter from treasury department dated April 30, 1918; I. T. S. 1919, ¶ 858.

[16] Revenue Act of 1921, § 214 (a) (1).

[17] Reg. 45, Art. 292. See Chapter 21 for a discussion of the deductibility of traveling expenses.

[18] O. D. 627, T. B. 33-20-1039.

gent upon continued payment of premiums by the employer. The employee has no option to take the amount of the premiums paid for the policy covering his life instead of the insurance. The policies have no paid-up value either to the employer or to the employee. Such insurance creates no debt on the part of the employer, pays no debt to the employee, and discharges no legal obligations resting upon the employee. The only benefit obtained by the employee himself is a feeling of contentment that provision has been made for his dependents, and the payment constitutes an investment on the part of the employer in increased efficiency. The same considerations apply to cases in which a portion of the premiums for group life insurance is paid by associations of employees, provided no contract covering such payment exists between the employer and the employees.[19]

Services in Cancellation of Indebtedness. If an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income.[20]

Voluntary Offerings Received by Clergymen. Although as a general rule gifts and gratuities are not income, yet Easter offerings, and fees received by clergymen for funerals, masses, marriages, baptisms, and sums paid for saying masses for the dead, are considered income, because, though in the form of gifts, they are in fact payment to the clergymen, evangelists, and religious workers for services rendered.[21] Christmas gifts to clergymen do not come within this category.[22] The question is whether or not the money is actually a gift or merely in the form of a gift. A clergyman is not liable to tax on amounts received by him during the year from his parish, if he turns over to the religious order of which he is a member all moneys received in excess of his actual living expenses on account of the vow of poverty which he has taken.[23]

Rental Value of Dwelling House Furnished to Clergyman. Under the 1918 Law it was held that where in addition to

[19] T. D. 2992, amending Reg. 45, Art. 33; T. B. 13-28-19; O. 1014, T. B. 12-20-793.

[20] Reg. 45, Art. 51.

[21] Reg. 45, Art. 32.

[22] T. D. 2090.

[23] O. D. 119, T. B. 3-19-180.

the salary paid a clergyman he was permitted to use the parsonage for living quarters free of charge the fair rental value of the parsonage was considered a part of his compensation for services rendered and as such was required to be reported as income.[24] The Revenue Act of 1921 expressly provides that the rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation shall be exempt.[25]

Rewards. A reward for the performance of a special service, such as prevention of a bank robbery, constitutes taxable income.[26]

Tips. Tips, though in the form of gifts, are in fact payment for services rendered and constitute income to the recipient.[27]

Supper Money. "Supper money" paid to an employee for voluntary performance of extra labor after regular business hours, such payment not being regarded as additional compensation nor charged to the salary account, is paid for the convenience of the employer and is not taxable income to the employee.[28]

Compensation Paid Other Than in Cash. Salaries, wages, or compensation for personal services are income "in whatever form paid." Where services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received.[29] Where there is no stipulation as to the value of service, and payment for service is made with something other than money, the market or reasonable value of the thing taken in payment is the amount to be included as income.[30]

USE OF PROPERTY OF EMPLOYER. Where an employee uses his employer's property, horses, automobile, etc., by permission, and not by legal right as a part of his compensation for services, such use is in the nature of a gift from which no taxable income arises to the employee.

LIVING QUARTERS, BOARD OR LODGING. When living quarters, such as camps, are furnished to employees for the convenience

[24] O. D. 862, T. B. 14-21-1544.
[25] Revenue Act of 1921, § 213 (b) 11.
[26] O. D. 602, T. B. 30-20-1088.
[27] Reg. 45, Art. 32.
[28] O. D. 514, T. B. 21-20-950.
[29] Reg. 45, Art. 33. See footnote 1.
[30] Reg. 33 Rev., Art. 4.

of the employer, the value need not be added to the cash compensation of the employee, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax.[31] Where, from the location and nature of the work, it is necessary that employees engaged in fishing and canning be furnished with lodging and sustenance, the value of such lodging and sustenance may be considered as being furnished for the convenience of the employer and need not be included in the income of the employees.[32] Where the employees of a hospital are subject to immediate service on demand at any time during the day and night and on that account are required to accept quarters and meals at the hospital, the value of such quarters and meals may be considered as being furnished for the convenience of the hospital and does not represent additional compensation. On the other hand, where the employees are on duty a certain specified number of hours each day and could, if they so desired, obtain meals and lodging

[31] Reg. 33 Rev., Art. 34; Reg. 45, Arts. 33, 292; T. D. 2090. In this connection the case of Tennant v. Smith (1892) A. C. 150, 66 L. T. 327, 3 Tax Cas. 158, is interesting. It appeared in this case that the appellant Tennant was agent for a bank, and was bound as part of his duty to occupy the bank house as custodier of the whole premises belonging to the bank, and also for the transaction of any special bank business after bank hours. He was not entitled to sublet the bank house or use it for other than bank business, and in the event of his ceasing to hold his office he was under obligation to quit the premises forthwith. In holding that Tennant was not in receipt of any taxable income by reason of the use as living quarters of the bank house, the various lords writing opinions freely conceded that such use might be a substantial benefit to Tennant. Lord Watson said: * * * "I do not think it comes within the category of profits, because that word, in its ordinary acceptation, appears to me to denote something acquired which the acquirer becomes possessed of and can dispose of to his advantage—in other words, money—*or that which can be turned to pecuniary account.*" Lord Macnaghten said: * * * "It is a tax on what 'comes in'—on actual receipts." * * * "No doubt if the appellant had to find lodgings for himself he might have to pay for them. His income goes further because he is relieved from that expense. But a person is chargeable for income tax under Schedule D, as well as under Schedule E, *not on what saves his pocket, but on what goes into his pocket.* And the benefit which the appellant derives from having a rent-free house provided for him by the bank, brings in nothing which can be reckoned up as a receipt or properly described as income." This case might, of course, be decided differently under the American law because compensation for personal services was involved and such compensation is taxable under the Revenue Acts of 1918 and 1921 "in whatever form paid." (§ 213 (a).)

[32] O. D. 814, T. B. 8-21-1459.

elsewhere, the value of the board and lodging furnished is additional compensation.[33]

Stock Received in Exchange for Services. Compensation paid an employee of a corporation in its stock is, if the stock has a market value, to be treated as if the corporation sold the stock for its market value and paid the employee in cash.[34]

Promissory Notes Received in Exchange for Services. Promissory notes received in payment for services, and not merely as security for such payment, constitute income to the amount of their fair market value.[35]

Services Rendered Prior to March 1, 1913. Where services were rendered prior to March 1, 1913, but paid for thereafter, the amount received is taxable income to the extent of the excess of such amount over the fair market value on March 1, 1913, of the principal of the claim for compensation for such services and any interest which had then accrued. A claim for this purpose is a right existing unconditionally on March 1, 1913, and then assignable, whether presently payable or not. Interest does not, of course, include dividends on corporate stock.[36] In a recent case an individual was president and active manager of a corporation for a number of years prior to March 1, 1913. It was deemed that his services for the years 1909, 1910, 1911, and 1912, were such as reasonably to entitle him to additional compensation. No agreement as to the amount of the additional compensation was ever arrived at until December, 1913. The president, relying upon the promise of the two directors, became indebted to the company, this indebtedness being carried on the company's books as overdrafts. These overdrafts amounted in December, 1913, to $70,000. In that month, with the concurrence of himself and two of the other four directors he was given a credit on the corporate books for $50,000, leaving a balance of $20,000 owing to the company on his overdrafts. The court held that the president of the company was taxable in 1913 on the $50,000 allowed to him in that year as additional compensation

[33] O. D. 915, T. B. 20-21-1634.

[34] Reg. 45, Art. 33 as amended by T. D. 2992, Treasury Bulletin 13-20-819; O. D. 570, T. B. 27-20-1039. Conversely, in an early ruling of the treasury department under the 1913 Law it was held that commissions allowed salesmen paid in stock might be deducted as expense if so charged on the books of the corporation, at the actual value of such stock. (Reg. 33, Art. 117).

[35] Reg. 45, Art. 34. See Chapter 14 for discussion of the manner of computing the value of income received in the form of promissory notes.

[36] Reg. 45, Art. 87 as amended by T. D. 3206, T. B. 33-21-1767. See O. D. 956, T. B. 26-21-1700; O. D. 1116, T. B. 48-21-1946. See also Chapter 33 for a full discussion of this subject.

for the four prior years.[37] An executor is entitled, under the laws of New York, to one-half of his commission for receiving the estate of the deceased, and one-half for paying it out. In the case of commissions received subsequent to March 1, 1913, in an estate received prior to that date, one-half is in satisfaction of a claim which vested prior to March 1, 1913, and is a return of capital to the extent of its market value on that date.[38]

Compensation for Services Extending Over a Year. Where no determination of compensation is had until the completion of services, the amount received is income for the calendar year of its determination, if the return is rendered on the accrual basis; or for the taxable year in which received, if the return is rendered on the basis of receipts and disbursements.[39] A taxpayer who keeps no books of account, and to whom is paid upon the termination of services extending over a period of years, a lump sum in amount not previously agreed upon, as compensation for such services, must return as income in the year in which received the entire amount so paid him, even when such payment is accompanied by a statement proportioning the compensation over the years in which the services were rendered.[40] Where the compensation of a receiver, trustee, or similar fiduciary is awarded or paid at the conclusion of the trust, it is presumed, in the absence of satisfactory evidence to the contrary, that it did not accrue during the course of the trust, and it is accordingly taxable as income of the year when awarded or paid. Where it is understood at the beginning of the trust that the amount of the compensation is not to be determined until its conclusion, and this understanding is adhered to during the course of the trust and no payments are made on account of such compensation, this presumption becomes conclusive.[41]

[37] Holbrook v. Moore, U. S. Dist. Ct., East. Dist. of Missouri, Ct. 10, T. B. 17-21-1592. This was held even though the taxpayer had received and spent the money before March 1, 1913. But it was not certain that he would become entitled to any of the compensation in question until after that date.

[38] A. R. R. 321, T. B. 47-20-1311.

[39] Reg. 45, Art. 32; T. D. 2090; Jackson v. Smietanka, 272 Fed. 970; letter from treasury department, dated April 30, 1918; I. T. S. 1919, ¶ 858. This point is more fully discussed in Chapters 14 and 33. The latter chapter contains a full discussion of *when* items of income should be reported.

[40] Jackson v. Smietanka, 272 Fed. 970; T. D. 2960, T. B. 3-20-683; State ex rel. Houghton v. Phelps, (Wis.) 176 N. W. 217. See also O. D. 956, T. B. 26-21-1700.

[41] T. B. R. 12, T. B. 3-19-178. This was also the rule under the 1916 Law (T. D. 2135).

Compensation to Federal Government Officers and Employees. Compensation received as such by officers and employees, whether elected or appointed, of the United States, or of Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia is subject to tax whether paid in cash or in other forms.[42] Compensation received by federal reserve agents and their assistants, as well as other employees of federal reserve banks, is subject to tax.[43] The entire sum received by federal officers and employees, however, is not necessarily taxable as will be indicated in the following paragraphs.[44]

AMOUNTS WITHHELD TO PROVIDE ANNUITIES. The amounts deducted and withheld from the basic salary, pay or compensation of employees in the civil service of the United States in accordance with the provisions of the act approved May 22, 1920, is taxable income. The total compensation of the employees should be reported in gross income and no corresponding deduction may be taken for the amounts withheld, as such amounts are payments made toward the purchase of annuities provided for in the act. The annuities paid to retired employees are subject to tax to the extent that the aggregate amount of the payments exceeds the amounts withheld from the compensation of the employees.[45] If an employee leaves the civil service before he is eligible to retirement and receives the amount of salary withheld, together with interest, he should report only the amount of interest received by him as income for the year in which received.[46]

LIVING QUARTERS. Commutation of quarters and the money equivalent of quarters furnished in kind should be returned as income. When quarters are furnished in kind of a less number of rooms than the number allowed by law, the money equivalent only of the number of rooms actually assigned should be returned as income. When quarters are furnished of a greater number of rooms than the number allowed by law, it is to be assumed that the excess number is assigned for the convenience of the government, and the money equivalent only of the number of rooms allowed by law should be returned as income.[47] The value of living quarters, subsistence, laundry, heat and light furnished to officers and employees of the public health service is taxable income.[48]

42 Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a).
43 O. D. 15, T. B. 1-19-27.
44 T. D. 2079.
45 T. D. 3112, T. B. 3-21-1403.
46 O. D. 823, T. B. 9-21-1475.
47 T. D. 2079; O. D. 921, T. B. 21-21-1647.
48 O. D. 1098, T. B. 46-21-1917.

HEAT AND LIGHT. Amounts received by, or paid for, an officer for heat and light should be returned as income. This includes the money equivalent, as fixed by the government, of heat and light furnished to an officer occupying public quarters.[49] Amounts expended for heat and light are in the nature of personal living expenses and differ in this respect from amounts furnished for mileage, the latter being in the nature of a business expense or an expense of the employer rather than that of the employee.

MILEAGE. Officers and employees of the government were required under the 1918 Law to return as income any excess of the mileage allowance received by them over their actual expenses for railroad fares.[50] The Revenue Act of 1921 permits the deduction of traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business.[51] No reason appears why this provision should not be applicable to federal officers and employees.

REIMBURSEMENT FOR ACTUAL EXPENSES. Amounts paid by the government in the nature of reimbursement for subsistence and other items of actual expense incurred while absent on business for the government are not required to be returned as income.[52] If expended solely in connection with their official duties and if no part of the same is diverted for personal use, any expense money received by naval attaches to be expended for entertaining and exceptional purposes in connection with their duties, is not subject to tax.[53]

PER DIEM ALLOWANCES. The total per diem allowance is income and it has been ruled that there may be taken as a deduction for expense, the amount actually expended from such allowance for actual necessary traveling expenses.[54]

Compensation of Soldiers and Sailors. Under the 1918 Law a person of either sex in active service in the military or naval forces might exclude from gross income his or her compensation received during the recent war from the United States up to the amount of $3,500 in any taxable year.[55] A bonus paid by a

[49] T. D. 2079.

[50] Reg. 45, Art. 292. See the paragraph "Traveling Expenses", supra. See T. D. 2079 and O. D. 921, T. B. 21-21-1647; Galm v. U. S., 39 Ct. Cls. 55.

[51] Revenue Act of 1921, § 214 (a) (1).

[52] T. D. 2079.

[53] O. D. 36, T. B. 1-19-48.

[54] Reg. 33 Rev., Art. 8; T. D. 2079; T. D. 2124. See, however, the paragraph "Traveling Expenses", supra.

[55] Revenue Act of 1918, § 213 (b). See Chapter 3, footnote 11.

state to its residents who served in the military or naval forces during the war with Germany does not constitute taxable income to the recipient.[56] By joint resolution of Congress approved by the President, March 3, 1921, that date was fixed as the date of the termination of the war for certain purposes. In order to entitle a person in the military or naval forces of the United States to the $3,500 exemption, the salary or compensation must have been received during the period January 1, 1918, to and including March 3, 1921.[57] A person is in active service if he is actually serving in such forces, not necessarily in the field or in the theatre of war, and is not merely on the retired or reserve list. Accordingly, if such a person received compensation from the United States of $3,500 or less and had no other income of an amount sufficient in itself to require him to render a return of income, he was not required to make a return.[58] The following compensation was held not to be within the exemption of $3,500:

1. Compensation received by persons serving in the American Merchant Marine Sea Training Bureau;[59]
2. Retainer pay received by naval reservists while on inactive duty;[60]
3. Compensation received by persons in the army transport service;[61]
4. Compensation received by persons in the military service from the Spruce division;[62]
5. Compensation received from the war department by a civilian flying instructor;[63]
6. Compensation of the employees of the commission on training camp activities;[64]
7. Compensation received by an officer of the national guard detailed to the general staff college;[65]
8. Compensation received by employees of the Knights of Columbus war activities;[66]

[56] O. D. 286, T. B. 22-19-533.
[57] O. D. 900, T. B. 18-21-1608.
[58] Reg. 45, Art 86.
[59] O. D. 329, T. B. 28-19-613.
[60] O. D. 463, T. B. 16-20-860.
[61] O. D. 462, T. B. 16-28-59.
[62] O. D. 214, T. B. 11-19-376; (Op. A. G. 3); T. D. 3242, T. B. 47-21-1932.
[63] O. D. 122, T. B. 3-19-183.
[64] O. D. 27, T. B. 1-19-39.
[65] O. D. 435; T. B. 14-20-828.
[66] O. D. 485, T. B. 18-20-898.

9. Compensation received by persons in the military or naval forces for services between April 6, 1917, and December 31, 1917;[67]

10. Compensation received by the personnel of the United States Merchant Marine enrolled in accordance with rules and regulations of the shipping board;[68]

11. Compensation received by members of draft boards;[69]

12. Compensation of employees of the public health service whether officers or civilians;[70]

13. Compensation of teachers on duty in the medical department at large.[71]

The following compensation was held to be within the exemption of $3,500 according to persons in active service in the military or naval forces of the United States by the 1918 Law:

1. Compensation of army contract surgeons;[72] and
2. Compensation of army field clerks.[73]

The following items were to be included in the $3,500 exemption:

(a) Bonus payable upon discharge;

(b) Mileage from point of discharge to point of enlistment, and

(c) Ration money covering the periods of absence from camp on furlough.[74]

The personal exemption allowed married men and the exemption for dependents were not included in the $3,500 exemption.[75]

Under the 1918 Law it was held that compensation paid to or in behalf of discharged soldiers, sailors, or members of the army and navy nurse corps, provided for in the Vocational Rehabilitation Act and amendments thereto, is income subject to tax. Such income included, besides money payments, the value of courses

[67] O. D. 337, T. B. 29-19-625.

[68] O. D. 663, T. B. 38-20-1202.

[69] Reg. 45, Art. 86.

[70] O. D. 904, T. B. 19-21-1618, reversing O. D. 495, T. B. 19-20-915.

[71] O. D. 752, T. B. 51-20-1351.

[72] Reg. 45, Art. 86.

[73] O. D. 435, T. B. 14-20-827. The right to the $3,500 exemption in the case of "reconstruction aids" in the army is dependent upon their status, whether military or civil, while engaged in such work. The exemption would not be allowed in the case of a civilian so engaged, whereas it would be allowed in the case of a member of the military forces under similar assignment without change of status. (O. D. 435, T. B. 14-20-827).

[74] O. D. 370, T. B. 3-20-686.

[75] O. D. 123, T. B. 3-19-184.

pursued, also books, material, etc., which were furnished without charge to and became the property of the recipients, and were not included in the cost of such courses.[76]

The Revenue Act of 1921 exempts amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war.[77]

Compensation of Federal Judges. The salaries of judges of the Supreme Court and inferior courts of the United States, in office at the time the law was passed, were exempt from the tax, under the 1916 Law, but this did not include the salaries of such judges as were appointed subsequent to the passage of the law, or to retired judges. The Revenue Acts of 1918 and 1921 expressly tax the compensation of all federal judges,[78] but in a recent case it has been held that this provision is unconstitutional.[79] It has been held by the treasury department that the compensation of federal judges appointed after the passage of the Revenue Act of 1918 is subject to tax.[80] Judges of territorial courts are held not to be exempt.[81] Members of the Board of United States

76 Sol. Op. 97, T. B. 14-21-1543.

77 Revenue Act of 1921, § 213 (b) (9).

78 Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a). Revenue Act of 1916, § 4; T. D. 2090. This exemption was inserted in view of the provision of the Federal Constitution, Art. 3, § 1, which guarantees that the compensation of federal judges shall not be diminished during their continuance in office. See opinion of Justice Field in Pollock v. Farmers Loan and Trust Company, 157 U. S. 429, and 13 Op. Atty. Gen. 161. On February 16, 1863, Chief Justice Taney of the United States Supreme Court wrote a letter to Hon. S. P. Chase, then secretary of the treasury, vigorously protesting against the constitutionality of any construction of the income tax then in force as embracing a tax on salaries of the judges of the Supreme Court. The secretary of the treasury, having ignored this letter, Chief Justice Taney procured its entry on the records of the Supreme Court on March 10, 1863 (Tyler's Life of Taney, pp. 432, 435). It was deemed unpatriotic to resist the collection of the tax, at least during the war, and it was collected until toward the end of 1869, when the opinion of the attorney-general referred to above was rendered, advising against the constitutionality of any tax upon the salary of the President of the United States and upon the judges of the Supreme Court.

79 Evans v. Gore, 253 U. S. 245. The treasury department has ruled that this case is not applicable to referees in bankruptcy and that the fees received by such referees are subject to tax. (O. D. 678, T. B. 41-20-1229.)

80 T. D. 3049, T. B. 33-20-1127.

81 O. D. 899, T. B. 18-21-1606.

General Appraisers are not exempt, since the board is not a court nor are its members federal judges.[82]

Compensation of the President of the United States. Under the 1916 Law, the compensation of the President of the United States in office at the time the law was passed was exempt from the tax during the term for which he was elected.[83] Compensation received as such by the President of the United States is expressly taxable under the 1918 and 1921 Laws.[84] In a recent decision of the United States Supreme Court, which in reality presented the question whether the provision of the Revenue Act of 1918 taxing the salaries of federal judges was constitutional it has been clearly indicated that the provision taxing the salary of the President of the United States is unconstitutional.[85] The salaries of Presidents elected after the passage of the Revenue Act of 1918 will be held taxable.[86]

Compensation of Officers and Employees of a State or Political Subdivision Thereof. Neither the Revenue Act of 1918 nor the Revenue Act of 1921 expressly exempt "the compensation of all officers and employees of a state, or any political subdivision thereof, except when such compensation is paid by the United States government," as did the 1916 Law.[87] It would seem, therefore, that such compensation is intended to be made taxable,[88] but the treasury department has ruled that compensation paid its officers and employees by a state or political subdivision thereof, including fees received by notaries public commissioned by states and the commissions of receivers appointed by state courts, are

82 O. D. 902, T. B. 19-21-1616.

83 Revenue Act of 1916, § 4. In an opinion of the attorney-general in 1869 it was held that a specific tax by the United States upon the salary of the President in office at the time the act was passed, to be deducted from the salary which otherwise would be paid to him, would be a diminution of his compensation in contravention of Article 2, § 1, Clause 7, of the Federal Constitution, which provides that the compensation of the President shall neither be increased nor diminished during the period for which he shall have been elected. 13 Op. Atty. Gen. 162. This consideration no doubt moved Congress to grant the exemption in the 1916 Law.

84 Revenue Act of 1921, § 213 (b); Revenue Act of 1918, § 213 (a).

85 Evans v. Gore, 253 U. S. 245.

86 T. D. 3049, T. B. 33-20-1127.

87 Revenue Act of 1916, § 4. For the exemption provided by the 1916 Law, see Revenue Act of 1916, § 23; Reg. 33 Rev., Art. 4; Reg. 33, Art. 5; T. D. 2152.

88 The general opinion that a federal tax on the salaries of officers or employees of a state is unconstitutional, is based on the cases, among others, of Collector v. Day, 11 Wall. 113; Freedman v. Sigel, 9 Fed. Cas. No. 5,080; U. S. v. Ritchie, 27 Fed. Cas. No. 16,168. In the Day case, Day, who was

not taxable. Employees of universities receiving salaries paid in part or in whole from funds available under the Smith-Lever Act of May 8, 1914, who are officers or employees of a state, are not required to return as taxable income the salaries so received. This is also true with respect to the Act of August 30, 1890, relating to colleges for the benefit of agriculture and the mechanic arts, and to the act of March 2, 1887, relating to agricultural experiment stations in such colleges.[89] An industrial commission was established by a state and certain amounts were paid into the commission's fund by manufacturers and others, based on their pay rolls. Such funds are under the supervision and sole control of the state and are deposited in the state treasury. The law

Judge of the Court of Probate and Insolvency for a county in Massachusetts, was taxed on his salary in 1866 and 1867 as such officer. The question was presented "whether or not it is competent for Congress, under the Constitution of the United States, to impose a tax upon the salary of a judicial officer of a state." The court considers at some length the case of Dobbins v. Erie Co., 16 Pet. 435, in which it was decided that a state could not levy a tax on the salary of an officer of the United States, because (1) such officer was a means or instrumentality employed for carrying into effect some of the legitimate powers of the federal government which could not be interfered with by the states, (2) the salary or compensation for the service of the officer was inseparably connected with the office, and (3) if the officer was exempt, his salary was equally exempt. The court also considered at some length the leading case of McCullough v. Maryland, 4 Wheat. 316, and discussed the relationship between the federal government and the separate states. Conceding that the exemption of the salaries in question from income tax rested upon "necessary implication," the court placed its decision on the grounds that (1) in respect to the powers reserved to them, one of which was the power to maintain a judicial department, the separate states are as sovereign and independent as the federal government, (2) that the unimpaired existence of such reserved powers is as essential in one case as in the other, and (3) the means and instrumentalities employed by the states for carrying on the operations of their governments, for preserving their existence and for fulfilling the duties assigned to them by the Constitution, must be left free and unimpaired and must not be crippled or defeated by another taxing power. Opinion to the contrary is founded largely upon the recent cases of Peck v. Lowe, 247 U. S. 165, and U. S. Glue Co. v. Oak Creek, 247 U. S. 321. The 1918 Revenue Bill as introduced into Congress expressly taxed such salaries, but the provision was stricken out in the senate, and not restored by the conference committee, although that committee restored the provision taxing the salary of the President and salaries of federal judges. Under the Canadian form of government, it has been held that a provincial legislature has power to tax the official income of an officer of the Dominion government. (Abbott v. St. John, 40 Can. Sup. Ct. 597; Webb v. Outrin, (1907) App. Cas. 81, 95 L. T. 850; 23 T. L. R. 147; contra the discredited case of Leprohon v. Ottawa, 2 Ont. App. 522).

[89] Reg. 45, Art. 85. Letter from treasury department dated May 17, 1919; I. T. S. 1919, ¶ 3335; 31 Op. Atty. Gen. 441.

provides for the payment out of such fund of the compensation of a secretary, physicians and other persons performing services for the commission. It has been held that a surgeon who performs surgical operations on individuals sustaining injuries while in the employ of the manufacturers, such surgeon not being under contract with the state but being paid out of the commission fund on a fee basis and devoting only a portion of his time to the treatment of such employees, is not an employee of the state. Compensation, therefore, received for the above services, is income subject to tax.[90] In order to be exempt, the recipient of income from a state or political subdivision thereof must be an *officer* or *employee* of such state or political subdivision.

WHO ARE OFFICERS AND EMPLOYEES OF A STATE OR POLITICAL SUBDIVISION THEREOF. An officer is a person who occupies a position in the service of the government, the tenure of which is continuous and not temporary and the duties of which are established by law or regulations and not by agreement. An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional, temporary or specific in character or object.[91] Compensation paid by a state or political subdivision thereof to its officers and employees is exempt even though the recipient be a nonresident alien.[92]

In addition to the above, the following are officers or employees of a state or political subdivision thereof within the meaning of exemption granted to the compensation of such officers and employees by the treasury department (but not by the Revenue Acts of 1918 or 1921):

1. Persons serving on the jury of a state, county, or municipal court;[93]

2. A chief engineer appointed by a sewerage commission created by the common council of a state under authority of a state statute;[94]

3. A referee in drainage appointed by the district judge of a state judicial district in which the drainage project is located, such judge being vested with authority to provide for the pay-

[90] O. D. 1038, T. B. 38-21-1828.

[91] A. R. R. 664 (Sol. Op. 122), T. B. 45-21-1906.

[92] O. D. 274, T. B. 19-19-497.

[93] O. D. 434, T. B. 14-20-826.

[94] O. D. 309, T. B. 25-19-582.

ment of the referee's salary, to regulate his duties, and to discharge him at pleasure;[95]

4. A county surveyor who is paid from county funds even though on a *per diem* basis;[96]

5. Members of the Virginia Debt Commission;[97]

6. The attorney for the state comptroller appointed under the New York Transfer (Inheritance) Tax Law to look after the state's interests in the collection of inheritance taxes; such attorney receiving as compensation a commission on the transfer of most of the estates and in some cases such fees and allowances as the state comptroller deems reasonable and proper;[98]

7. Officers of the national guard;

8. A deputy sheriff of New Hampshire;[99] and

9. An attorney-at-law, employed by the collector of revenues in a county, under an agreement to render personal services as directed by the collector.[100]

The following are not officers or employees of a state or political subdivision thereof within the meaning of exemption granted to the compensation of such officers and employees:

1. Trustees of a corporation who have filed an application for winding up the affairs of the corporation in accordance with the laws of Connecticut, such trustees not being receivers in fact and not exercising a public function under an appointment of the court;[101]

2. Administrators and executors;[102]

3. An individual who exercises a public function under an appointment issued by a court officer for a particular transaction or purpose for a limited time and who in the exercise of such function is not vested with the character of either an officer or employee of the state or political subdivision thereof;[103]

4. Witnesses summoned by a state attorney (as to fees);[104]

[95] O. D. 525, T. B. 22-20-968.

[96] O. D. 33, T. B. 1-19-45.

[97] O. D. 257, T. B. 16-19-460.

[98] O. D. 494, T. B. 19-20-14.

[99] O. D. 1053, T. B. 40-21-1853.

[100] O. D. 1099, T. B. 46-21-1919.

[101] O. D. 369, T. B. 3-20-685. The compensation of such trustees is fixed by the court.

[102] O. D. 256, T. B. 16-19-459.

[103] O. D. 256, T. B. 16-19-459.

[104] O. D. 195, T. B. 9-19-338.

5. Clerical assistants employed by the clerks of state courts in connection with the administration of the federal naturalization laws and paid out of fees collected by the state court clerks;[105]

6. Individuals employed in constructing a causeway and paid from the funds of three railway companies and a county which is part owner of the project;[106]

7. A "special counsel" of a municipality;[107]

8. Individuals holding the positions of "State Agent of Normal Schools for Whites," "State Agent of Normal Schools for Negroes," and "High School Inspector," which positions are created by the Superintendent of Public Instruction of a state without statutory authority;[108] and

9. A partnership of civil engineers employed by a state irrigation district to serve as consulting and supervisory engineers in connection with the development of the irrigation district under a contract prescribing a stipulated payment per annum in addition to expenses and for all time in excess of 60 days in any one year, a certain sum per day in addition to expenses, and under which contract the engineering work in connection with the irrigation district is to be performed under the general direction of the partnership;[109]

10. A bank, designated a depositary for state and county funds and receiving for its services a fixed sum of money per year;[110]

11. Building and real estate experts employed by the board of local improvements of a city, not appointed to any position, the tenure and duties of which were established by law and receiving a percentage of the value of the buildings and real estate appraised.[111]

When a receiver is appointed by a state court for the assets of a corporation, part of which are located in the state appointing

[105] O. D. 484, T. B. 18-20-897.

[106] O. D. 553, T. B. 25-20-1013.

[107] Letter from treasury department dated April 15, 1919; I. T. S. 1919, ¶ 3313.

[108] O. D. 449, T. B. 15-20-845.

[109] O. D. 545, T. B. 24-20-1001. The partnership in this case had similar contracts with other districts and counties and accepted business from the public in general. The work was not subject to the direction and control of the directors of the irrigation district, but its relation to the directors was similar to the relation between an attorney and a client who pays an annual retainer for any legal services the client may require.

[110] O. D. 1090, T. B. 45-21-1907.

[111] O. D. 1075, T. B. 43-21-1884.

the receiver and the remainder in another state, the federal district court for the latter state appointing the same person as receiver for the assets located in that state, and the fees from the receivership are allowed in a lump sum, the exemption accorded to compensation received by an officer of a state or political subdivision thereof applies only to that portion of the fee of such receiver attributable to his appointment by the state court.[112]

SALARIES PAID TO TEACHERS. Salaries paid to teachers are exempt only where the educational institution is maintained wholly by the state and the relation of employer and employee exists between the state and the teacher. They are not exempt merely because the teachers are engaged in educational work, nor because they are pensioned by the state.[113] Where the laws of a certain state require that all children under 16 years of age, who are employed, shall attend a regular school for eight hours a week and a certain corporation, instead of sending its employees to an outside school, conducts one in its place of business, placing it in charge of a teacher who is certified by the supervisor of schools of another state but subject to the authority of a city in the former state, the salary of the teacher being paid and the school maintained not by the state or political subdivision thereof, but by and for the convenience of the corporation, it has been held that the teacher is not exempt as an officer or employee of a state or political subdivision thereof.[114] The compensation of teachers of the territory of Hawaii is subject to tax.[115]

PENSIONS. Pensions received from a state or political subdivision thereof by retired employees are exempt,[116] but pensions paid by the state of Kentucky to Confederate Civil War veterans are not exempt.[117]

PILOT FEES. It has been held that the compensation of a pilot for a port in Florida, where such pilot was appointed by the board of pilot commissioners appointed by the governor of the state, is not exempt because the pilot receives his compensation from fees paid by the steamship companies to the board of pilot commissioners, rather than from funds of the state.[118]

[112] O. D. 503, T. B. 20-20-933.
[113] O. D. 826, T. B. 4-19-214.
[114] O. D. 963, T. B. 27-21-1711.
[115] O. D. 12, T. B. 1-19-24.
[116] O. D. 434, T. B. 14-20-826.
[117] O. D. 903, T. B. 19-21-1617.
[118] O. D. 916, T. B. 20-21-1636.

Compensation of Public Library Employees. The employees of a public library incorporated by special act of the legislature of a state are not exempt from tax where the control and management of the corporation and of all moneys appropriated by the city for the care and maintenance of the library are vested in the board of directors consisting of the president, vice president, the three managers of the corporation, two citizens of the city appointed by the mayor, and three officials of the city, the expenses of the corporation being chiefly provided for by an appropriation by the state and the city, and the power of appointment and removal of employees being exercised by the board of directors. In such case the relationship of employer and employees does not exist between the state or the city and the employees of the library. The moneys appropriated by the state and city are turned over to the corporation to be used as the board of directors may direct. The fact that the compensation of employees may be paid out of moneys appropriated by the state or the city does not change their status as employees of the corporation.[119]

[119] O. D. 973, T. B. 28-21-1725.

CHAPTER 16

INCOME FROM BUSINESS, TRADE OR COMMERCE

The Revenue Act of 1921, like the Revenue Act of 1918, provides that gains, profits and income derived from trades, businesses or commerce, or the transaction of any business carried on for gain or profit,[1] shall be taxable. The general rules respecting income from such sources are discussed in this chapter, and the reflection of income by means of inventories.[2] The subjects of income derived from sales or dealings in property, and income from interest, rent and royalties are discussed in other chapters.[3]

Gross Income from Business. In the case of a manufacturing, merchandising or mining business "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses or losses, or for items not ordinarily used in computing the cost of goods sold. Gross income includes all amounts received by the taxpayer as allowances for amortization, from whatever source and by whatever name called. The allowance for amortization authorized by the statute must be taken by way of explicit deduction from gross income.[4] It is not permissible for an individual, whose business is that of a sole proprietor, to compute his income from his business on one basis and his income from other sources on another basis, either with respect to the method of accounting or the taxable period.[5] A taxpayer engaged as a sole proprietor of a business selling provisions must subtract from his total purchases for the year, or add to his total sales for the year, the cost of provisions withdrawn for personal or family use.[6]

Income of Contractors. Persons engaged in contracting operations, who have uncompleted contracts, in some cases perhaps running for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally

1 Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a).

2 See Chapter 25 for discussion of the subject of losses in inventories.

3 See Chapters 17 and 18.

4 Reg. 45, Art. 35; Reg. 33 Rev., Art. 93; Reg. 33, Arts. 106 and 107.

5 O. D. 941, T. B. 23-21-1673. See Chapter 33.

6 O. D. 998, T. B. 34-21-1777.

completed any and all moneys received in payment will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from such gross income should include and be limited to the expenditures made on account of such completed contracts. Or the percentage of profit from the contract may be estimated on the basis of percentage of completion, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned as income for that year. Upon the completion of a contract if it is found that as a result of such estimate or apportionment the income of any year or years has been overstated or understated, the taxpayer should file amended returns for such year or years.[7] A taxpayer, having once made his election to prepare his return so that the gross income will be arrived at on the basis of completed work, will not later be permitted to file amended returns for the purpose of reporting income computed upon the basis of the expenses incurred on such contract each year during the performance of the contract. However, he may, without permission, report his income from contracts thereafter entered into by him computed upon the basis of expenses incurred on such contracts during the year.[8]

Income from Export Business. Under the 1916 Law income from the business of exporting goods was held by the treasury department to be taxable. It has also been held that a tax on such income is not a tax on the articles exported, and therefore not unconstitutional in that regard, since if Congress has power to lay a tax up to the time when articles are put in course of exportation, the conclusion is unavoidable that the net income arising from exportation when it has been completed or after the exportation and sale are fully consummated, is likewise subject to taxation under general laws.[9]

Discounts. The discount allowed to a corporation purchasing new equipment need not be reported as income, but the cost of the equipment as charged to capital must represent only the net cost after making allowance for the discount in question.[10]

[7] Reg. 45, Art. 36; Reg. 33 Rev., Art. 121; T. D. 2161.

[8] O. D. 933, T. B. 22-21-1661.

[9] Peck v. Lowe, 247 U. S. 165.

[10] Letter from Treasury Department dated November 26, 1918; I. T. S., 1921, ¶ 951.

Bank Discounts. In cases wherein banks or other corporations loan money by discounting bills or notes, one of two methods is used in determining the amount of discount to be reported as income, namely: (1) if the bank or corporation makes a practice of crediting such discount directly to a "discount account" or to profit and loss, the total amount thus credited during the year should be considered income and should be so reported, regardless of the fact that a portion of this amount may represent discount paid in advance and not then earned; (2) if the bank or corporation follows the practice of crediting such discount to an "unearned discount account," and later, as the discount becomes earned, debits the unearned account and credits an "earned discount account" with the amount so earned, the total amount credited to the "earned discount account" during the year should be considered income and should be so reported. The corporation reporting income of this character should state in a memorandum attached to its return which of the two methods was used in determining the amount of discount returned.[11] The latter of the two above methods has been generally recognized as the correct method of computing such income and the comptroller of the currency has suggested the adoption of this method by all national banks. Banks which in the past have treated discount as income before it was actually earned and during the taxable year 1918 have placed the discount account upon an accrual basis will be required to submit all necessary information and an amended return for the taxable year 1917, and will be permitted to submit (or the Commissioner may require) amended returns for all prior years during which the taxpayer was subject to tax. Additional taxes for prior years found to be due upon such re-examinations will be paid upon the basis of the amended returns in the ordinary way. Where it appears that prior taxes have been paid in excess of the amount properly due such excess will to the extent possible be credited against future income and profits taxes.[12]

Manufacturers Selling on the Coupon System. Where a manufacturing corporation sells a large part of its product on the coupon system, this system being a mutually advantageous arrangement between purchaser and manufacturer whereby the purchaser orders and pays for a quantity of the product in excess of his immediate needs, thereby securing quantity discount, the balance of the order to be delivered as needed upon

[11] Reg. 33 Rev., Art. 114.

[12] Reg. 45, Art. 23. Letter from Treasury Department dated February 11, 1919; I. T. S. 1919, ¶ 3248.

presentation of coupons issued by the manufacturer at the time of the sale, the full purchase price of the coupon being refunded to the purchaser if any coupons are not used or if the company is unable to make delivery of goods upon demand, may treat the sales value of the coupons issued and outstanding at the close of the taxable year as a liability and base the amount of gross profits from sales upon the coupons redeemed in merchandise during the year.[13]

Inventories. The Revenue Act of 1921 is identical with the Revenue Act of 1918 in regard to the use of inventories. Taxpayers engaged in manufacturing or mercantile business usually determine their net income by inventory, purchases during the year plus the stock on hand at the beginning of the year being subtracted from sales during the year plus stock on hand at the close of the year, or vice versa, to ascertain the gain or loss. The treasury department's first recognition of this system required that in every case where the annual gain or loss was determined by inventory, the merchandise must be inventoried at cost price, as any loss in salable value would ultimately be reflected in the sales during the year when the goods were disposed of. This rule permitting inventories on the basis of cost only was later altered and new rules established for the purpose of income and excess-profits tax returns, permitting inventories at cost or market value, whichever is lower.[14] Except where inventories are allowed at cost or market, gain or loss must in all cases be determined on the basis of cost.[15] In no cases should overhead charges be included in inventory.[16] It is provided by the Revenue Acts of 1921 and 1918 that whenever, in the opinion of the Commissioner, the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner with the approval of the secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income,[17] and gain or loss is determined in the case of prop-

[13] O. D. 827, T. B. 9-21-1479.

[14] T. D. 2609. The attorney-general has advised on the authority of Doyle v. Mitchell Brothers, 247 U. S. 179, that the methods of taking inventories authorized by T. D. 2609 are permissible. (T. D. 2744; T. D. 2649.) See Chapter 14 as to "Inventories of Foreign Exchange."

[15] T. D. 2609. For the rule where goods were purchased prior to March 1, 1913, see Chapter 17.

[16] See instructions on back of Form 1031 for 1916.

[17] Revenue Act of 1921, § 203. The Revenue Act of 1918 contained the same provision (Revenue Act of 1918, § 203).

erty acquired on or after March 1, 1913, on the basis of the cost thereof or inventory value, if the inventory is made in accordance with the above provision.[18] Where a taxpayer manufactures property and keeps it on hand for a number of years, until it is sold in the taxable year 1918, the gain derived is the difference between the selling price and the cost; or the difference between the selling price and the inventory value of the goods at the beginning of the taxable year, on the inventory basis regularly followed by the taxpayer; that is, either an inventory basis of cost or an inventory basis of cost or market value, whichever is lower. It is not permissible to use market value except when it becomes material in taking inventory on the basis of cost or market value, whichever is lower.[19] Where a taxpayer takes inventories on the basis of cost or market price, whichever is lower, goods which were acquired before March 1, 1913, will be inventoried at the market value on March 1, 1913, or at the market price at the time of the inventory, whichever is lower.[20] Where a taxpayer in rendering his returns for years prior to 1918 exercised his option to include excise taxes in the cost of merchandise in calculating inventories it has been ruled that he is not entitled to change his method and treat such taxes paid during 1918 as business expenses.[21]

NEED OF INVENTORIES. In order to reflect the net income correctly, inventories at the beginning and ending of each year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption or use in productive processes, to-

[18] Revenue Act of 1921, § 202 (a) 1; Revenue Act of 1918, § 202 (a) 2. Copies of inventory need not be filed with the return, but it is recommended that the taxpayer attach to his return a summarized analysis of his inventories. (I. T. S. 1919, ¶ 3958.)

[19] S. 926, T. B. 1-19-10. In this case the taxpayer was taxed in 1918 on an appreciation in value occurring gradually over several years merely because the sale occurred in 1918. The case illustrates the effect of the limitation of inventories to (a) cost, or (b) cost or market, whichever is lower, to be as follows: 1 A gradual appreciation in value may not be prorated over the years of appreciation because inventories may not be taken at market if market is higher than cost; 2 A gradual depreciation in value may be prorated over the years of depreciation because inventories may be taken at market if market is lower than cost. See Chapter 17 as to property acquired before March 1, 1913.

[20] S. 1003, T. B. 5-19-245. This ruling was made before the decisions in Goodrich v. Edwards, 65 L. Ed. 450, and Walsh v. Brewster, 65 L. Ed. 451 U. S. Sup. Ct. For the effect of these decisions, see Chapter 17.

[21] A. R. M. 121, T. B. 16-21-1574.

gether with all finished or partly finished goods. Title to the merchandise included in the inventory should be vested in the taxpayer and goods merely ordered for future delivery and for which no transfer of title has been effected should be excluded. The inventory should include merchandise sold but not shipped to the customer at the date of the inventory, together with any merchandise out upon consignment, but if such goods have been included in the sales of the taxable year they should not be taken in the inventory. It should also include merchandise purchased, although not actually received, title to which has passed to the purchaser. In this regard care should be exercised to take into the accounts all invoices or other charges in respect of merchandise properly included in the inventory, but which is in transit or for other reasons has not been reduced to physical possession.[22]

The delivery of copper bullion to a smelting and refining company where it is mixed with other bullion and concentrates of different metallic contents under a contract by which the smelting and refining company is to return the equivalent of the metallic contents of such ore previously determined by assay, less commissions and other allowable charges, constitutes a sale and not a bailment. Only so much of the metals as had been redelivered by the refining company at the close of the taxable year belonged to and should have been included in the inventory of the taxpayer as of that date.[23]

Where in 1919 an American corporation advanced a sum of money to an English corporation for the purpose of enabling the English corporation to purchase raw material to manufacture certain articles which the American corporation had contracted to sell for the English corporation and at the time the American corporation took its inventory, December 1, 1919, the articles had not been received by it, such advance to the English corporation was considered a loan, and the value of the

[22] Reg. 45, Arts. 24, 1581; T. D. 2609.

[23] S. 1373, T. B. 20-20-930. The general rule is that when by the terms of the contract under which property is delivered by an owner to another, the latter is under no obligation to return the specific property either in its identical form or in some other form in which its identity may be traced, but is authorized to substitute something else in its place, either money or some other equivalent, the transaction is not a bailment, but is a sale or exchange. (Austin v. Seligman, 18 Fed. 519; Powder Co. v. Burkhardt, 97 U. S. 110; Woodward v. Semans, 125 Ind. 330, 25 N. E. 444; Buffum v. Merry, 4 Fed. Cas. 2112.)

claim could not be inventoried at its depreciated value owing to the decline in exchange.[24]

The net income of a person engaged in the business of propagation and culture of oysters can not be properly computed upon the basis of inventories.[25]

A taxpayer, engaged in the real estate business, is not permitted to inventory real estate which is held for sale for the purpose of calculating net income subject to income tax.[26]

In 1918 the United States army commandeered certain quantities of canned goods subject to price fixing and allotment by the United States food administration. In one of these cases a tentative price (subsequently increased) was fixed by the food administration, shipments were to be made subject to an initial inspection and the government had until July 1, 1919, to make final inspection as to quantity. The taxpayer guaranteed the goods against "spoils" and "swells" until July 1, 1919. Spoiled or swelled goods were to be held subject to the seller's order. The taxpayer made all the shipments in 1918 and the goods were paid for subject to the above guarantee. In May, 1919, a certain portion of the goods, on inspection, was found to be spoiled, and in order to finally dispose of the matter without great expense and loss, it was agreed in a bill of re-sale, executed by the representatives of the army and the taxpayer, that the taxpayer should take back the goods which it had delivered and pay to the United States the provisional price for each case, less certain deductions by way of allowance to cover the cost of new cases, recasing, relabeling, etc. The taxpayer claimed an adjustment of 1918 taxes based upon the rejection of canned goods sold to the army in 1918, by reducing the rejected goods to a valuation of cost as at December 31, 1918. It was held, however, that the resale to the taxpayer at the original price, less certain definite concessions, was in substance a compromise sale and a new transaction. As of December 31, 1918, the goods in question were not the property of the taxpayer, they had been shipped out by him and he was eventually paid in accordance with the terms of the purchase. This stock, therefore, could not be considered as a part of the inventory of the taxpayer as of December 31, 1918, particularly since it was shown that all of the goods purchased by the government under these contracts had not been returned to the taxpayer or accounted for. The taxpayer had an opportunity in the taxable year 1919 to determine his loss by

24 O. D. 541, T. B. 24-20-994.
25 O. D. 684, T. B. 42-20-1240.
26 O. D. 848, T. B. 12-21-1517.

a subsequent sale or other disposition of the goods so bought back from the government.[27]

COTTON MERCHANTS AND DEALERS IN GRAIN. Cotton merchants and dealers in grains and its products have contended for such a modification in the regulations with regard to inventories as will permit them to include in, or make a part of, their inventories "hedges", or transactions in "futures" which are recognized practices in their businesses and which transactions are entered into, it is claimed, for the purpose of stabilizing the cost of the commodities in which they deal and to remove their operations from the realm of speculation. These "hedges" are transactions in which contracts are made for the purchase or sale of these commodities for delivery at some time in the future, a profit or loss being realized at the time the delivery is made, either actually or constructively, but not before then. In the case of cotton merchants, these "hedges" are always sales contracts for the future delivery of cotton made at the time and to the same extent that "spot cotton" is actually purchased. But in the case of merchants dealing in grain and its products, these "hedges" consist of contracts for purchases to be received at some future time as well as for sales for future delivery.

The modifications of the existing regulations for which the various taxpayers have contended are reducible to the following general propositions:

1. To *add* to the value of the physical inventory:

(a) The value, at "cost" or "cost or market, whichever is lower," of all commodities purchased to be received at some future date, the title to which does not pass to the taxpayer until the commodities have been reduced to physical possession;

(b) Potential losses, not realized within the taxable year, on transactions in futures.

2. To *deduct* from the value of the physical inventory:

(c) The value, at "cost" or "cost or market, whichever is lower," of all commodities sold to be delivered at some future date, the title to which does not pass to the purchaser until the date of delivery, irrespective of whether or not such commodities are in the possession of the taxpayer at the date of the contract for sale;

(d) Potential gains, not realized within the taxable year, on transactions in futures.

In the case of (a) above, the department holds that since the taxpayers do not own the commodities in question, but have only a contract for their purchase, they cannot properly include

[27] A. R. M. 129, T. B. 24-21-1683.

such property in an inventory as of that date. This also disposes by analogy of (c), for if commodities purchased, but not received, cannot be included in an inventory where title has not passed, it is clear that under the same circumstances and conditions, commodities sold but not delivered cannot be deducted therefrom. With regard to (b) and (d) above, potential gains or losses on transactions in "futures" cannot form an integral part of the *cost* of the commodity in which the taxpayer deals. The actual purchase of a commodity, and the simultaneous sale of the same quantity of the commodity for future delivery, do not constitute one transaction. They are two entirely separate and distinct transactions, neither one of which can have any effect upon the other. If the commodity purchased is on hand at the end of the taxable year it forms a part of the physical inventory in which it should be included at "cost" or "cost or market, whichever is lower," and whatever potential loss or gain may be shown at the time of the inventory in the "futures" transaction does not affect that cost in the slightest degree. The fact that these transactions may be simultaneous does not make them identical, since the commodity may be retained and the "future" contract "covered" or closed out or the commodity may be disposed of and the "future" contract still remain open without any effect whatever upon the other transaction of each pair. There is, in fact, no profit or loss in the purchase of a commodity until the transaction has been completed by the sale of that particular commodity, nor is there any profit or loss in a transaction in "futures" until the transaction has actually been closed.

The department, therefore, holds:

(1) That transactions in "futures" unclosed at the end of the taxable year form no integral part of the cost of the commodity included in the taxpayer's physical inventory; and

(2) That the basis of (a) cost, or (b) cost or market, whichever is lower, is the only admissible basis for the valuation of a physical inventory in the computation of statutory net income for income tax purposes.[28]

[28] A. R. M. 100, T. B. 49-20-1331. It has been held, however, that dealers in cotton and grain and in such other commodities as are dealt in in similar manner may, for the purpose of determining taxable income, incorporate in their balance sheets at the close of any taxable year such open "future" contracts to which they are parties as are "hedges" against actual "spot" or cash transactions, provided that no particularly speculative transactions in "futures" not offset by actual "spot" or cash transactions may be so included or taken into the taxpayer's account in any manner until such transactions are actually closed by liquidation (A. R. M. 135, T. B. 31-21-1750).

Valuation of Inventories. Inventories must be valued at (a) cost or (b) cost or market, whichever is lower. Whichever basis is adopted must be applied consistently to the entire inventory. A taxpayer may, regardless of his past practice, adopt the basis of cost or market, whichever is lower, for his 1920 inventory, provided a disclosure of the fact and that it represents a change is made in the return. Thereafter changes can be made only after permission is secured from the commissioner. Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased.[29]

The rule applicable to all industries is that inventories should be taken on the basis "(a) cost, or (b) cost or market, whichever is lower." It is recognized that in some industries the actual cost of production can not be ascertained accurately, and it is therefore necessary to approximate a cost value by using selling market prices as a starting point and reducing such selling market prices in each case by an amount sufficient to eliminate the element of profit. This rule is applicable to the inventories of farmers and stockmen, and is widely used in many lines of industry, notably in those types of mining and manufacturing in which a product of more than one grade or more than one kind is obtained by a common operation.[30]

If the actual accrued charges which must eventually be paid by a taxpayer, either directly or indirectly through credits to customers, can be accurately determined and applied to the goods actually in stock at any specified date, such charges if set on the books as an existing liability, form proper additions to the cost price of the goods then on hand; but this additional value must be determined by charges actually paid or to be paid and cannot be arrived at by the application of any empirical formula and cannot include interest, except on money actually borrowed for the purpose of carrying the goods, nor any appreciation in value of the goods.[31]

A taxpayer who for many years has elected to take inventory only every two years, and used an estimated inventory in the return for the intermediate year, making any necessary adjust-

[29] Reg. 45, Art. 1582, as amended by T. D. 3108, T. B. 1-21-1382; A. R. R. 517, T. B. 22-21-1667.

[30] O. 844, T. B. 6-19-268.

[31] A. R. R. 140, T. B. 23-20-982.

ments in the return for the following year when an actual inventory was taken, may not apportion his total earnings for the two years 1917 and 1918 equally between such years for income tax purposes.[32] After the year 1918 taxpayers will not be permitted to adopt one period for inventorying and closing their books applicable to one part of their business and a different period applicable to another part thereof.[33]

Liquor dealers were not permitted to omit from inventory as at December 31, 1919, stocks of liquor then on hand with the understanding that if the liquor was subsequently disposed of for value the total value received would be returned as income of the year in which the disposition was made.[34]

A dealer may value used or secondhand automobiles included in a closing inventory on the basis of cost or market, whichever is lower, if he can furnish satisfactory evidence of the market value of such secondhand automobiles at the date of the inventory; otherwise they must be valued at cost.[35]

Change from Cost or Market to Cost. When request is made for permission to change from cost or market, whichever is lower, to cost for pricing inventories at the close of 1919, the permission will be granted since it will have no effect on the tax if market was above cost at the close of 1918, and will increase the tax if market was lower than cost at that date. The permission will, of course, be upon the condition that the new method be followed consistently thereafter. Under the tax laws prior to the Revenue Act of 1918, no specific reference was made to inventories, but under the regulations inventories were required to be taken at cost for every year until December 19, 1917.[36] As this date was only a few days prior to the end of the calendar year 1917, probably few taxpayers took advantage of the option to inventory at cost or market, whichever was lower, in making their 1917 return. The Revenue Act of 1918 specifically granted authority to provide for the taking of inventories on any basis consistent with sound commercial practices and which would reflect true income, and the regulations issued under that law authorized a change to cost or market, whichever was lower. In many lines of industry, however, market was above cost and inventories were consequently priced at cost. Where it can be shown that the market at the close of 1918 or 1919 was above

[32] O. D. 133, T. B. 4-19-211.
[33] O. D. 289, T. B. 23-19-541.
[34] A. R. M. 33, T. B. 9-20-765.
[35] O. D. 888, T. B. 17-21-1590.
[36] See T. D. 2609.

cost the taxpayer may, for the succeeding year, elect to take his inventory upon a cost or market basis, whichever is lower, provided that such practice is consistently adhered to in the future. But where market at the close of 1918 or 1919 was below cost and the taxpayer thus had an opportunity to take inventories at a figure lower than cost, he will not be permitted to change from cost to cost or market, whichever is lower, where it appears that the principal reason for the change is the reduced tax payable. If, however, permission is granted in any of the above cases to change the method of pricing inventory, it is unnecessary to file any amended returns for the past years or make any change in the inventory by reason of the changed method of pricing. Where a change is necessitated because in the past a basis has been used not permitted by the regulations now nor then, amended returns on one or the other of the two bases now authorized from 1915 to date should be filed. If the adjustments due to the amendment of returns so affect the taxpayer as to occasion an inequality in the tax prior to the year 1915, such inequality may be remedied in the 1915 return by the deduction from or addition to the tax accruing in that year of an amount equal to the net amount overpaid or underpaid in prior years, such amount to be determined by filing with the return for 1915 a composite return for all prior years accompanied by a statement showing the total adjustment for each of the years and the net for the entire period.[37]

Valuation of Inventories on Basis of Average Cost or Average of Market Prices. The valuation of inventories on the basis of average cost[38] or average of market prices extending over a period of years[39] is not permitted by statute. The average cost method may be briefly described as follows: Materials purchased during the month are added both as to quantity and cost to the quantity and cost balance brought forward from the previous month, and an average cost at the close of the month is computed by dividing the total quantity into the total money figures. This average is then applied to the quantity of material used for manufacture during the month, and the amount so computed is credited to the material account.

The starting point in the computation of annual income must be the sales made during the year. It is the profits or losses upon these sales that are to be computed if any actuality is to

[37] A. R. M. 38, T. B. 13-20-804, as modified by A. R. M. 85, T. B. 43-20-1273; A. R. R. 506, T. B. 20-21-1631.

[38] T. B. R. 48, T. B. 16-19-457.

[39] T. B. M. 31, T. B. 6-19-269.

be attained. To do otherwise is to invite speculation and confusion. To give annual profits and losses meaning and integrity they must be arrived at by a logical computation which recognizes that each year acquires from its predecessor certain potentialities and turns over to the successor the property as it exists at the end of the year, and the basis of valuation at the beginning and end of the year must be reasonably uniform. If the starting point in the computation of annual profit or loss is the sales made during the period, the next step is the computation of the amount that is to be charged against such sales in respect of the cost of the goods that have gone into the sales. This must include (1) the cost of the goods included in the sales, less any portion of such cost which may have in effect, through a previous inventory based upon a market lower than cost, been charged against the sales of a previous year, and (2) where as a consistent policy inventories are taken upon the basis of market when it is less than cost, such further amount, if any, as may be required to reduce the goods in the inventory to the level of a lower present market. To charge against the sales of a year a sum less than the total found under (1) and (2) above will show as profits an amount larger than the profits actually realized upon the sales of the period. In a business requiring goods to be carried for lengthy periods and where an average method of inventory valuation is used, this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated. When the market is stable the average method will reflect with approximate accuracy the true profits, and in a business in which the turnover is rapid, the effect of such a method upon the computation of annual income is small as compared with a business in which it is necessary to carry goods, such as raw materials, for long periods. In such cases, so long as the annual profits are stated with substantial accuracy, taxpayers should not be required to make inventory changes which are annoying to them and which are without commensurate importance to the government. The average cost method of inventorying may, however, have an important effect upon taxation. The computation of net income upon such a basis results in an assignment of income to a year, not upon the basis of the transactions of the year, but upon the basis of transactions part of which spread over more than a year. To be strictly logical, such a method should, moreover, include a similar averaging of sales. This would tend toward uniformity of annual profits and might, in fact, reflect the profits as accurately as the partial

average method, but it would be a far departure from an actual computation. An annual accounting period is a fundamental requirement, and every computation of taxable net income must be made in conformity therewith. This the average cost inventory method fails to do, and its use cannot be approved as meeting the statutory requirement.[40]

Base Stock, Minimum and Cushion Methods. The "base stock," "minimum" or "cushion" methods of taking inventory are not permitted by the statute. According to the base stock method of taking inventories a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. This base stock method has not been sanctioned as an established accounting practice by the test of general acceptation or the test of time. The present income tax system is based upon an annual accounting period. The object of an inventory is to assign to an annual accounting period its profits and losses. The effect of the base stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. Each sale or exchange of property for other property having a market value is, however, in fact a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income.

The usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises not from a desire to measure capital and net income accurately, but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which leads bankers to write down their buildings to a nominal figure and to accumulate hidden reserves.

In substance, the base stock inventory results in offsetting an inventory gain of one year against an inventory loss of another rather than in assigning to each year its true gain or loss. The fact that the Revenue Acts of 1918 and 1921 in their provisions with respect to inventory loss and net loss authorize in some cases the carrying of a loss realized in one year into accounts

[40] T. B. R. 48, T. B. 16-19-457. A monthly average cost method has been permitted in the case of tobacco companies taking inventories by that method, no other method approaching theoretical accuracy being practicably possible. (A. R. R. 18, T. B. 3-20-680.)

of another year is some indication that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer. Furthermore, the argument that the application of the ordinary rules as to inventories results in hardship is met by the fact that Congress has authorized relief against hardship through the medium of these inventory and net loss provisions in cases which are within the terms thereof.[41]

The general conclusion that the base stock method does not conform to the requirements of the law, applies to "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices." Such goods will be deemed to be the goods most recently purchased. This presumption or inference is warranted because in the absence of evidence as to the actual fact it is more nearly true than any other. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will not be deemed to be the goods included in the minimum inventory.

In lieu of the base stock method, it was suggested that inventories be valued on a moving average basis for a period of five years, more or less. According to this method one-fifth, for example, of the inventory would be deemed to be the goods most recently purchased and the balance the goods on hand at the beginning of the year. Another method proposed was that the goods in the inventory be deemed to be the earliest rather than the latest purchases. These methods have been held open to the same objections as the base stock method.[42]

INVENTORIES AT COST. Cost means: (1) In the case of merchandise purchased, the invoice price less trade or other discounts except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods; (2) in the case of merchandise produced by the taxpayer, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost

[41] T. B. R. 65, T. B. 22-19-531. The British Committee on Financial Risks attaching to the holding of trading stocks, after an investigation and analysis of this subject, decided against the base stock method in a report submitted December 5, 1918.

[42] T. B. R. 65, T. B. 22-19-531.

of selling or return on capital whether by way of interest or profit. In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry.[43]

Taxpayers who as a matter of settled practice do not deduct cash discounts from purchases, but who take the merchandise purchased into their inventories at invoice price (less trade or other discounts other than strictly cash discounts), carrying the discounts in a discount account, may not, in valuing their closing inventories, deduct from the invoice price of the merchandise on hand at the close of the taxable year the average amount of cash discount received on such merchandise; neither may the amount of cash discount earned, to be reported as income, be decreased by an amount representing the estimated cash discount received on merchandise on hand at the close of the year.[44]

INVENTORIES AT MARKET. Under ordinary circumstances, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which ordinarily purchased by the taxpayer. This method of valuation is applicable in the cases (a) of goods purchased and on hand, (b) of basic elements of cost (materials, labor, and burden) in goods in process of manufacture, and (c) of finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost. Where no open market quotations are available, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific transactions in reasonable volume entered into in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where, owing to abnormal conditions, the taxpayer has regularly sold such merchandise at prices lower than the current bid price as above defined, the inventory may be valued at such prices, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market and the penalties prescribed for filing false and fraudulent returns may be asserted. Goods in process

[43] Reg. 45, Art. 1583.
[44] O. D. 326, T. B. 28-19-610.

of manufacture may be valued for purposes of the inventory on the lowest of the following bases: (1) The replacement or reproduction cost prevailing at the date of the inventory; or (2) the proper proportionate part of the actual finished cost; or, under abnormal conditions, (3) the proper proportionate part of the sales price of the finished product, account being taken in all cases of the proportionate part of the total cost of basic elements (materials, labor, and burden) represented in such goods in process of manufacture at the stages at which they are found on the date of the inventory. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted. He must be prepared to show both the cost and the market price of each article included in the inventory. It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case, when a market was established during the succeeding year, a claim may be filed for any loss sustained.[45]

Where a corporation, in taking its inventory on December 31, 1918, on the basis of cost or market, whichever was lower, used as the basis for such inventory the "asking prices" as of the date of the inventory, the department has held that the company may amend its inventory by using instead of "asking prices", the "fair bid prices." If at the end of 1918 abnormal conditions existed and there was, in fact, no market for such goods, the taxpayer may use as the basis for his inventory his actual sales for a reasonable period before and after the date of the inventory. It is not permissible, where no actual market exists, to value the inventory by prices fixed subsequent to the close of the taxable year.[46]

INVENTORIES BY DEALERS IN SECURITIES. A dealer in securities, who in his books of account regularly inventories unsold securities on hand either (a) at cost or (b) at cost or market, whichever is lower, may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years,

[45] T. D. 3109, T. B. 1-21-1383, amending Reg. 45, Art. 1584, previously amended by T. D. 3047, T. B. 32-20-1114.

[46] A. R. R. 487, T. B. 18-21-1609.

unless another be authorized by the Commissioner.[47] For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers, that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment.[48] A bank or other institution having a regularly established department for the merchandising of securities, even though that department is subordinate in importance to other departments, is entitled to the same benefit of using the basis above provided of inventorying securities acquired and held for resale, as one who is solely a dealer in securities. Insofar as the bank or other institution carries on, with an established place of business, a department for the merchandising of securities, it is in respect of such department treated in the same way as any other security merchant.[49] Taxpayers who buy and sell or hold securities for investment or speculation, and not in the course of an established business, and officers of corporations and members of partnerships, who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.[50]

An inventory method of accounts may be availed of by a dealer in securities only as to stocks owned by the dealer at the end of the year. In the process of a "short" sale legal title to stock is transferred from the lender to the borrower and from the borrower to the buyer, and then later from the borrower to the lender. The "short" sale dealer having no stock in his possession to which he has title, consequently has no stock which he can inventory at the end of the year; as soon as title was secured from the lender, it was passed on to the buyer. Since the statute does not authorize the inventorying of liabilities even though the liability is one to return specific property in kind on demand and inasmuch as the word "inventory" in its commonly accepted commercial meaning refers to the inventory-

[47] The rules as to valuation of inventories stated in an earlier paragraph, are applicable to dealers in securities. (M. 2703, T. B. 7-21-1442).

[48] Reg. 45, Art. 1585.

[49] Letter from treasury department dated June 28, 1919; I. T. S. 1921, ¶ 2717.

[50] Reg. 45, Art. 1585.

ing of assets only, a dealer in securities may not inventory stock sold "short" as of the end of the taxable year. Consequently, where a taxpayer has "borrowed" stock in order to make a "short" sale the gain or loss arising from the transaction cannot be accrued upon the books of the taxpayer at the close of his taxable year by treating as an offsetting obligation the market value of the stock sold "short" as of that date; the gain or loss is determined when the amount of stock sold "short" is repurchased for return to the lender and the transaction closed.[51]

INVENTORIES OF LUMBER MANUFACTURERS. Because of, the impracticability of determining accurately the costs properly assignable to each species, grade, and dimension of lumber making up the product of the mill, lumber manufacturers may use as a basis for pricing inventories the average cost to the manufacturer of producing the inventoried products during the taxable year for which the return of net income is made. If the quantity of lumber on hand at the time of inventory is greater than the total quantity of lumber produced during the current taxable year, it is evident that the excess stock has been carried over from the previous year's production, and such excess shall be valued at the average cost of production for the preceding taxable year. A taxpayer who regularly allocates in his books of account such average cost to the different kinds and grades of lumber in proportion to the selling value of such kinds and grades may, subject in each case to the approval of the Commissioner upon audit of the return, make his returns of net income on that basis. The term lumber manufacturer, as thus used, means a person who manufactures lumber from logs, as distinguished from a remanufacturer of lumber.[52]

INVENTORIES OF RETAIL DRY GOODS MERCHANTS. Retail dry goods dealers who employ the "retail method," will be permitted to make their returns upon that basis, provided (a) that the use of such method is designated upon the return, (b) that accurate accounts are kept, and (c) that such method be adhered to in subsequent years, unless a change is authorized by the Commissioner.[53] Other organizations and individual stores who conduct retail establishments and follow essentially the retail method of dry goods stores, may be allowed this method upon application to the Commissioner. While in its original ruling on this

[51] S. 1179, T. B. 24-19-558.
[52] T. D. 3024, T. B. 24-20-995.
[53] T. D. 3058, T. B. 35-20-1162.

subject[54] the treasury department designated the "retail method" a "cost" method of valuing inventories, it is recognized that while on a constant or rising market such method is approximately a "cost" basis, on a falling market it results in a reduction to "cost or market, whichever is lower."[55] The "retail method" consists in computing the "cost" of goods on hand from the "percentage of purchase mark-up" and the "retail value" of goods on hand. A taxpayer employing the "retail method" of valuing inventories should maintain and preserve in permanent form, for the inspection of internal revenue officers, the accounts and records of each year, together with a schedule of all mark-downs in each department, and such mark-downs should not be included in the computation of the retail value of goods on hand unless the goods so marked down have been actually sold.[56] There must be a permanent form of recording by departments, purchases showing the firm name, date of invoice, invoice cost and retail sales, stock, etc. It must be borne in mind that under no circumstances will arbitrary standard percentages of purchase mark-up be allowed in the determination of the "cost" or "cost or market" value of retail inventories, but that such percentages must be the purchase mark-up percentage disclosed by the department records of the fiscal period for which the return is made.[57] The following general plan of taking an inventory by the "retail method" will, it is believed, be found readily adaptable to the requirements of most retail dry goods dealers:

(A) The *percentage of purchase mark-up* is computed as follows: The value of all merchandise, as received, is recorded by departments at two prices, (a) invoice cost plus transportation, and (b) original retail sale price. These cost and retail values are accumulated as recorded during the year. The total retail value minus the total cost value equals the total purchase mark-up, which divided by the total retail value gives the percentage of purchase mark-up.[58] The words, "the value of all merchandise as received," is inclusive of inventory at the beginning of the period. The purchase mark-up must be computed as follows:

[54] Id.

[55] Letter from treasury department dated January 21, 1921; I. T. S. 1921, ¶ 2681.

[56] T. D. 3058, T. B. 35-20-1162.

[57] Letter from the treasury department dated January 21, 1921; I. T. S., 1921, ¶ 2681.

[58] T. D. 3058, T. B. 35-20-1162.

Cost: Inventory at cost at beginning: purchases at cost; transportation. Retail: Inventory at sales price: purchases at sales price. Within the meaning of this ruling, it is proper to include as a part of "original retail sales price" the actual increase in the original sales price which has been brought about by market conditions or by incorrect pricing when the goods were put into stock. For the convenience of the examining officer, a special form should be provided; complete information by items of the increase from the original retail must be shown; reference, if possible, must be made to the original invoice; entry and the reason for the increase freely explained. All such amended retail increases must be approved by the buyer of the department and merchandise manager or other responsible official and they should be so filed that quick reference to them may be made. Entry of such increased retail properly belongs in department purchase books, although it may be set up as a separate item in the accumulated records of the department. The same forms that are used to record such price increases should not be used for mark-downs and in no instances will a store be allowed to include as retail increases a mark-up which has been taken as a correction or cancellation of a mark-down; such mark-up must be regarded and treated in all cases as opposite to mark-down.[59]

(B) The *retail value of goods on hand* is computed as follows: A record is kept of (a) the amounts of all sales at retail, (b) any variations from the inventory prices of the preceding year of goods carried over from that year, and (c) any variations from the original sale prices, such as subsequent mark-ups or mark-downs. The retail value of the opening inventories plus the retail value of the purchases (plus or minus the algebraic sum of all subsequent mark-ups, and mark-downs in the case of goods actually sold) minus the retail value of the sales equals the retail value of the book inventory of goods on hand. Physical inventories by departments are taken of goods on hand at retail at the close of the taxable year, and the retail value of the book inventory of goods on hand is adjusted accordingly.

(C) The *cost of goods on hand* is computed by subtracting from 100% the percentage of purchase mark-up, which gives the percentage of cost, and multiplying the retail value of goods on hand by such percentage of cost.[60] The above deci-

[59] Letter from treasury department dated January 21, 1921; I. T. S. 1921, ¶ 2681.

[60] T. D. 3058, T. B. 35-20-1162.

sion is not intended to disturb the procedure in stores which have properly handled mark-downs, but instances where arbitary reductions from retail values have been made because of the desire to provide for depreciation and obsolescence with no actual offering to the public of the goods on which the mark-downs were claimed, cannot be recognized. Under no circumstances will a store be allowed to depreciate its stock in any way except by the offering of it to its customers at such reduced prices. The procedure of stores in regard to mark-downs will be deemed proper if in any fiscal year or period of that year the goods so marked down are in proportion to current sales, stock on hand, to mark-downs of preceding months of preceding year, or if evidence can be submitted as to market changes which have forced a reduction in retail prices necessary to bring about a parity with the selling price of the same goods which have been purchased or could be purchased at a reduced cost. A store which has employed this retail method in the past, may now specify in the return that such method is used, as a basis of valuing inventories, regardless of the fact that in past years it reported on a "cost" or "cost or market, whichever is lower" basis. However, the use of the retail method will not be recognized unless it has been correctly followed throughout the entire fiscal or calendar year period for which the return is made.[61]

[61] Letter from treasury department dated January 21, 1921; I. T. S. 1921, ¶ 2681.

CHAPTER 17

INCOME FROM SALES OR DEALINGS IN PROPERTY; QUASI CAPITAL TRANSACTIONS

Both the present law and the Revenue Act of 1918 expressly provide that gains, profits and income derived from sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property shall be taxable.[1] For some time after the enactment of the Sixteenth Amendment there were many who argued that gains resulting from an increase in capital or appreciation of capital assets could not be taxed, at least where the owner was not engaged in the business of dealing in such property, basing this contention on a leading case construing the Income Tax Act of 1864.[2] This argument has been definitely set at rest by several recent decisions of the United States Supreme Court, which held that such gains were intended to be taxed by the Revenue Act of 1916 and could constitutionally be taxed.[3] It was conceded by the solicitor-general in these cases that gain or loss upon any exchange of property was to be determined upon the basis of cost or acquisition value and not value on March 1, 1913, the gain or loss accruing before that date being excluded, however, for the purpose of computing net income. This concession, which became in effect a part of the decision of the Supreme Court, necessitated the modification of all the regulations theretofore issued involving the consideration that gains, profits and income accruing prior to March 1, 1913, were capital and so exempt.[4] The regulations, as so modified under the 1918 Law, establishing the basis for determining gain or loss upon an exchange of property for property are discussed later in this

[1] Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a).

[2] Gray v. Darlington, 15 Wall. 63.

[3] Walsh v. Brewster, 41 Sup. Ct. Rep. 392, T. B. 16-21-1573; Goodrich v. Edwards, 41 Sup. Ct. Rep. 390, T. B. 16-21-1572; Eldorado Coal Co. v. Mager, 65 L. Ed. 449, T. B. 16-21-1571; Merchants Loan & Trust Co. v. Smietanka, 41 Sup. Ct. Rep. 386, T. B. 16-21-1570; Darlington v. Mayer, U. S. Dist. Ct., N. Dist. Ill., affirmed by U. S. Supreme Court April 18, 1921, see I T. S. 1921, ¶ 2988. Taxpayers who omitted from gross income for 1920 or failed to make a disclosure of gains from the sale of capital assets have been held guilty of negligence or fraud, but if a full disclosure was made no negligence was imputed to the taxpayers. (M. 2791, T. B. 23-21-1674; M. 2739, T. B. 14-21-1542.)

[4] This amendment was accomplished in large part by T. D. 3206, T. B. 33-21-1767.

chapter. The basis so established by the treasury department has now been written into the Revenue Act of 1921 as the general rule for determining gain or loss upon an exchange of property for property. The special rules embodied in the 1918 Law, with respect to property included in inventory and property acquired by bequest, devise, or inheritance are in substance preserved in the present law. One important change made by the present law relates to the basis for determining gain or loss when the property exchanged was acquired by gift. This change is discussed below.[5]

While the general basis for determining gain or loss upon an exchange of property for property thus remains largely the same under the present law as it was under the Revenue Act of 1918, the present law, in many important respects, modifies the provisions of the 1918 Law upon this point. The general rule under the 1918 Law as to when a gain or loss could be said to occur indicates the first congressional recognition of the incongruities, hardships and absurdities involved in the taxation of gains said to be realized and the deduction of losses claimed to be sustained upon exchanges of property for property.[6] The most general of the modifications contained in the present law is the provision that no gain or loss shall be recognized upon an exchange of property for property unless the property received in exchange has a "readily realizable market value."[7] Other provisions involving substantial departures from the previous law are: (1) The provision with regard to the exchange of property held for investment, or productive use in trade or business, for property of a like kind or use; and (2) the provisions practically eliminating the element of taxable profit or deductible loss upon the organization, reorganization, merger, and consolidation of corporations. The new statute also provides for cases in which property of readily realizable market value and property without such value are received upon an exchange, and cases in which property of such value is received upon the organization or reorganization, in addition to stock or securities, of a corporation. The method adopted by the treasury

[5] See p. 458.

[6] It is stated by the Senate Finance Committee (see Report of that Committee on Internal Revenue Bill of 1921, p. 11): "Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business adjustments." (See also Report of Ways and Means Committee on Internal Revenue Bill of 1921, p. 10.)

[7] Revenue Act of 1921, § 202 (c).

department under the 1918 Law for taxing gains or profits upon installment transactions, discussed in the latter part of this chapter, is expressly sanctioned by the present law.[8] A further distinctive feature of the Revenue Act of 1921 is the so-called "capital gain" provision the effect of which is to limit the tax on gains derived from the sale or disposition of capital assets to 12½%.[9]

Taxation of Capital Gains. Many sales of farms, mineral properties and other capital assets have been prevented in the last years by the prohibitive taxes which would have been precipitated thereby. Under the Revenue Act of 1918 and previous laws, the profits derived on such sales were taxed at high surtax rates, like other income, and were taxed in the year of disposition though the profits represented the realization of a gradual appreciation extending over several years. Thus, income was unduly concentrated and higher surtax rates made to apply. Corporations were perhaps more fortunate than individuals in this respect because such undue concentration of income in one taxable year might be held to be an abnormality of income which would permit the excess-profits tax of the corporation to be calculated by reference to representative corporations, but this was an uncertain and inadequate remedy.[10]

The "capital gain" provision of the Revenue Act of 1921 is a recognition of these considerations.[11] The provision applies after December 31, 1921. Since the excess-profits tax is repealed as of that date there is no need for the provision to apply to corporations the income tax of which then is at the same rate (12½%) as the capital gain rate, and it is expressly made inapplicable to corporations. Any taxpayer (not a corporation) who for any taxable year (after 1921) derives a capital net gain, as defined below, may at his election, in lieu of the ordinary normal tax and surtax, pay thereon a tax computed as follows:

A partial tax is first computed upon the basis of the ordinary net income at the rates and in the ordinary manner (that is, the normal tax and the surtaxes are computed on such ordinary net income) and the total tax will be this amount plus 12½% of the capital net gain; but if the taxpayer elects to be taxed under this provision the total tax must in no such case be less than 12½% of the total net income. The total tax thus de-

[8] See Revenue Act of 1921, § 202.

[9] See Revenue Act of 1921, § 206.

[10] See Chapter 43.

[11] In Great Britain capital gain or loss is ignored in computing net income. The 1921 Law takes an intermediate position between the extreme views embodied in the 1918 Law and the British law.

termined is to be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under Title II of the Revenue Act of 1921 (the income tax title).[12]

DEFINITION. For the purpose of the provision indicated in the previous paragraph, the Revenue Act of 1921 has adopted the following definitions:

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921;

(3) The term "capital deductions" means such deductions as are allowed for the purpose of computing net income and are properly allocable to or chargeable against items of capital gain;

(4) The term "capital net gain" means the excess of the total amount of capital gain over the sum of the capital deductions and capital losses;

(5) The term "ordinary net income" means the net income, computed in accordance with the provisions of Title II, after excluding all items of capital gain, capital loss, and capital deductions; and

(6) The term "capital assets" means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.[13]

PARTNERSHIPS AND ESTATES AND TRUSTS. In the case of a partnership or of an estate or trust, the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, will be determined under rules and regulations to be prescribed by the Commissioner with the approval of the secretary, and will be separately shown in the return of the partnership or estate or trust, and will be taxed to the member or beneficiary or to the estate or trust, but at the rates and in the manner indicated above.[14]

[12] Revenue Act of 1921, § 206 (b).
[13] Revenue Act of 1921, § 206 (a).
[14] Revenue Act of 1921, § 206 (c).

Illustration of Computation of Tax of Taxpayer Electing to Be Taxed at 12½% Upon Capital Net Gains. The computation of tax by a taxpayer electing in 1922 to be taxed under the capital gain provision may be illustrated as follows:

Capital gains		$100,000
Capital losses	$20,000	
Capital deductions	10,000	30,000
Capital net gain		$ 70,000
Gross income (excluding capital gains)		$150,000
Deductions (excluding capital losses and deductions)		70,000
Ordinary net income		$ 80,000

Partial Tax on Ordinary Net Income
Normal Tax
$80,000 minus $2,000 (personal exemption) equals $78,000

First $4,000 @ 4%	$ 160
Remaining $74,000 @ 8%	5,920
Surtax	13,660
Partial tax on ordinary net income	$19,740
Tax on capital net gain ($70,000) @12½%	8,750
Total tax	$28,490

The tax of this taxpayer, without the benefit of the "capital gain" provision, would be $57,840; the provision will save him $29,350.

Exchange of Property Held for Investment or for Productive Use. One of the most essential changes made by the Revenue Act of 1921 is the provision that "when any such property (viz., real, personal or mixed property) held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use," no gain or loss will be recognized even if the property received in exchange has a "readily realizable market value." Upon such an exchange the property received is to be treated as taking the place of the property ex-

changed. If money, or other property of a "readily realizable market value" is received upon such an exchange, in addition to the property of "like kind or use," such money or the fair market value of such other property received in exchange is to be applied against and reduce the basis (for ascertaining gain or loss) of the property exchanged, and if such money or the fair market value of such other property is in excess of such basis, the excess is taxable.[15] These provisions have no counterpart in the Revenue Act of 1918. Their effect is apt to be far-reaching. The language used is broad. The provision may be separated into two parts: (1) where property held for investment is exchanged for property of a like kind or use;[16] and (2) when property held for productive use in trade or business (not including stock in trade or other property held primarily for sale) is exchanged for property of a like kind or use. There is no limitation upon the phrase "property held for investment." The statute does not even say property held "only" or "primarily" for investment. In a degree the element of investment enters into the holding of almost all property. Apparently the phrase includes all forms of property. An individual will apparently incur no tax upon the exchange of real estate held for investment for other similar real estate. Nor would an individual seem to be taxable upon an exchange of stocks held for investment for other stocks, or of bonds for bonds in like manner. These considerations are apt to have a revolutionary effect upon the real estate and brokerage business, and indeed on all sales and dealings in property. A change of investments produces no taxable income; and the selling of securities and other property for cash followed by a repurchase of other securities with the proceeds will be largely abandoned in favor of a trading or exchanging of the old securities directly for new securities, any discrepancy in value being adjusted by a cash payment which will be less than the basis provided for ascertaining gain or loss. It seems that the stock of one company is property of a "like kind" to the stock of another company; it may be held that common stock and preferred stock are not property of a "like kind." Again the parenthetical expression "stock-in-trade or other property held primarily for sale" is apt to raise administrative difficulties. It will not be easy to determine when property held for productive use in a trade or business is held "primarily for sale";

[15] Revenue Act of 1921, § 202 (c) 1, (d) 1, (e).

[16] The words "investment, or" were inserted in the bill by the conferees at the last moment. They were originally introduced, however, in the House (see Conference Report of Revenue Bill of 1921, p. 17).

and it will be no easier to determine when property is held for "productive use in a trade or business." This is illustrated, for instance, by the difficulties and litigation which arose in connection with the words "business or trade" as used in the loss provision of the 1916 Law.[17] Although permitting the tax-free exchange of much property the exchange of which for other property produced taxable profit, the provision will also prohibit the deduction of many losses of a character which have hitherto been deductible.

Basis for Determining Gain or Loss From Sale. For the purpose of ascertaining the gain derived or the loss sustained from the sale or exchange of property, the basis provided by the Revenue Act of 1918 was (a) its "fair market price or value" as of March 1, 1913, if acquired prior thereto, or (b) if acquired on or after that date its cost, or its approved inventory value, the gain, profit or income derived from sales or dealings in property being the amount by which the selling price of the property exceeds such "fair market price or value," cost, or approved inventory value.[18] In the recent cases in the Supreme Court involving the taxation of profits derived from the sale of capital assets,[19] the government admitted that the Commissioner had hitherto been construing the statute erroneously and that (a) no tax could be imposed when the selling price of property was less than the purchase price, even though a gain might be reflected in a difference between the selling price and the value of the property on March 1, 1913, and (b) that no deductible loss occurred unless the selling price was less than the purchase price, even though a loss might be reflected in a difference between the selling price and the value of the property on March 1, 1913. In other words, it was admitted that the statute contemplated the taxation and deduction only of real or actual gains or losses, represented by a difference between selling price and cost. Prior to the enactment of the Revenue Act of 1921 the treasury department (acting under the authority of the 1918 Law) summarized the general rule bearing upon the determination of gain or loss resulting from the sale or

[17] See Revenue Act of 1916, § 6 (a) fifth.

[18] Revenue Act of 1918, § 202 (a); Reg. 45, Art. 1561, as amended by T. D. 3206, T. B. 33-21-1767. The above provision establishing fair market price or value as of March 1, 1913, as a basis in the case of property acquired prior to that date appeared first in the 1916 Law, no reference being made in the 1909 Law or the 1913 Law to any basis when assets disposed of were acquired prior to the incidence of the tax.

[19] See cases cited in footnote 3.

other disposition of property acquired before March 1, 1913, as this general rule was affected by the above admission and sustained by the Supreme Court.[20] This departmental summary has now been adopted by the Revenue Act of 1921 as the general basis for determining gain or loss in the case of property acquired before March 1, 1913, and has been enacted in detail in that statute. The statute also changes the basis provided by the 1918 Law for the ascertainment of gain derived or loss sustained in the case of the disposition of property acquired by gift. Otherwise it will be noted that the present statute adopts substantially the basis set forth in the Revenue Act of 1918. The basis so provided[21] by the present law is as follows:

"(a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

"(1) In the case of such property, which should be included in the inventory, the basis shall be the last inventory value thereof;

"(2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. * * *

[20] See Reg. 45, Art. 1561. It is to be regretted that the Supreme Court did not pass expressly upon the subject matter of the above admission made by the solicitor-general. With regard to gains represented by a difference between selling price and value on March 1, 1913, in cases in which the selling price was less than purchase price, the admission of the solicitor was undoubtedly necessary, under the sixteenth amendment, because such a gain could not constitutionally be taxed. But the allowance of any deduction for loss is a matter in which Congress is not inhibited by any constitutional limitation, and to deny the deduction of losses represented by a difference between selling price and value on March 1, 1913, where the selling price was less than purchase price, is, in effect, to neutralize a loss occurring after the incidence of the tax by an admittedly nontaxable gain accruing prior to the incidence of the tax. The 1918 law plainly stated that such a loss should be an allowable deduction and the plain terms of the statute, where no constitutional limitations intervene, should be respected, whatever the result. (See Chapter 47.) Under the 1921 law the intention of Congress to follow the solicitor's admission is clear, but a provision of this law may not be used in interpreting a previous statute.

[21] Revenue Act of 1921, § 202 (a) (b). The basis in regard to property acquired by gift is not quoted in full at this point. It will be found in full in a special discussion of gains derived upon the sale of such property (see p. 458). In regard to property acquired before March 1, 1913, the statute is an enactment in detail of the basis set forth in Article 1561 of Regulations 45, as amended by T. D. 3206, T. B. 33-21-1767.

"(3) In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition. * * *

"(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

"(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

"(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

"(3) If the amount realized therefor is more than such basis, but not more than its fair market price or value as of March 1, 1913, or less than such basis, but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income."

Basis in Case of Property Acquired Before March 1, 1913. The statutory basis provided for determining the gain derived or loss sustained upon the disposition of property acquired before March 1, 1913, has been indicated in the preceding paragraph. This basis is the same as that most recently adopted by the treasury department under the 1918 Law and the following tabular summary[22] made by the department under that law will, therefore, be helpful under the present law:

In the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the taxable gain is the excess of the amount realized therefor over such fair market value.

Cost.	Fair market value March 1, 1913.	Sale price.	Taxable gain.
$10,000	$15,000	$20,000	$5,000. Excess of amount realized over fair market value as at March 1, 1913. Gain accruing prior to March 1, 1913, not taxable.

[22] Reg. 45, Art 1561, as amended by T. D. 3206. T. B. 33-21-1767; O. D. 1035, T. B. 38-21-1825, overruling such decisions as T. B. M. 73, T. B. 19-19-493; A. R. 667, T. B. 45-21-1903.

In the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor.

Cost.	Fair market value March 1, 1913.	Sale price.	Deductible loss.
$10,000	$5,000	$3,000	$2,000. Excess of fair market value over amount realized. Loss accruing prior to March 1, 1913, not deductible.

No gain or loss is recognized in the case of property acquired before March 1, 1913, and sold or disposed of at more than cost, but at less than its fair market value as of that date.

Cost.	Fair market value March 1, 1913.	Sale price.	
$10,000	$30,000	$20,000	No taxable gain or deductible loss. Reason: A gain on whole transaction, which gain is attributable to period prior to March 1, 1913.

No gain or loss is recognized in the case of property acquired before March 1, 1913, and sold or disposed of at less than cost but at more than its fair market value as of that date.

Cost.	Fair market value March 1, 1913.	Sale price.	
$10,000	$3,000	$5,000	No taxable gain or deductible loss. Reason: A loss on whole transaction, which loss is attributable to period prior to March 1, 1913.

Where the cost is equal to or greater than the fair market value as at March 1, 1913, and the selling price exceeds the cost, the taxable gain is the excess of the selling price over the cost.

Cost.	Fair market value March 1, 1913.	Sale price.	Taxable gain.
$10,000	$5,000	$20,000	$10,000. Reason: Gain on whole transaction, all of which is attributable to period subsequent to March 1, 1913.

Where the fair market value as at March 1, 1913, is greater than the cost and the selling price is less than the cost, the deductible loss is the amount by which the cost exceeds the selling price.

Cost.	Fair market value March 1, 1913.	Sale price.	Deductible loss.
$10 000	$15,000	$5,000	$5,000. Reason: Loss on whole transaction, all of which is attributable to period subsequent to March 1, 1913. Only actual loss sustained deductible.

SUBSEQUENT SALE. The amount of income derived from a subsequent sale for cash of property received in exchange for other property on or after March 1, 1913, is the excess of the amount so received over the "readily realizable" market value ("fair" market value, under the 1918 Law) of the property acquired at the date of the acquisition. If the property received in exchange is substantially the same property or has no such value, then no gain or loss is realized, but the new property is to be regarded as substituted for the old property and upon the sale of the new property the amount of income derived is the excess of the amount so received over the cost of the old property. However, if the old property was acquired prior to March 1, 1913, and its fair market price or value as of that date is in excess of its cost but less than the amount received, the taxable gain is the excess over such value as of March 1, 1913, of the amount received. No gain is recognized if the property is sold at more than the cost of the old property, but at less than its fair market value as of March 1, 1913.[23]

Cost of Property. The cost of property is the actual price paid for it when acquired, together with (a) the expense of acquiring it, (b) the expense of selling it, (c) the cost of any improvements or betterments which have been made with respect to the property,[24] and (d) carrying charges, provided they have been capitalized and have not been deducted in any annual return of the owner filed subsequent to the incidence of the income tax.[25] Interest should not be added to the purchase price in order to ascertain cost,[26] and cost must be reduced by the amount

[23] Reg. 45, Art. 1564, as amended by T. D. 3206, T. B. 33-21-1767.

[24] T. D. 2090.

[25] T. D. 2137. This rule should be retained under the present law.

[26] Walsh v. Brewster, 41 Sup. Ct. Rep. 392; Hays v. Gauley Mountain Coal Co., 247 U. S. 189. In this case the court said: "That the sale resulted in a

of any depreciation or depletion sustained and deducted since February 28, 1913.[27] Cost is sometimes composed of elements difficult to reduce to dollars and cents. In a case in which a taxpayer purchased land from his mother the consideration was (a) an amount of cash, (b) a promise to support the mother for life, and (c) taking out an insurance policy payable to the mother if the taxpayer should predecease her. Upon a sale of the land the cost was determined by adding to (a) the cost of a year's maintenance of the mother multiplied by her life expectancy and the premiums paid or to be paid during such life expectancy of the mother.[28]

COST OF LEASE. Where a lease providing that repairs or improvements made by the lessee reverted to the lessor upon termination, the lessee in computing his profit upon an assignment of the lease is entitled to deduct from the sale price the cost of improvements less so much of such cost as had previously been returned through depreciation deductions.[29]

STOCK RECEIVED AS BONUS. It was held under the 1918 Law that where common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price must be fairly apportioned between the stock and securities purchased for the purpose of determining the portion of the consideration attributable to each class of stock or securities and so representing its cost, but if that should be impracticable in any case, no

gain or profit to the extent of $210,000, the difference between the buying and selling prices, is not to be doubted, for there is no merit in the contention that interest should be added to the purchase price in order to ascertain its cost. The money that went into the purchase was not loaned at interest; on the contrary, by the very fact of the purchase it was placed where it could not earn interest for the respondent in the ordinary sense, and the gain represented by the increase of selling price over cost price must be regarded as a substitute for whatever return some other form of investment might have yielded." The court refused to pass on this question in State ex rel. Bundy v. Nygaard (Wis.), 158 N. W. 87.

[27] Reg. 45, Art. 1561, as amended by T. D. 3206, T. B. 33-21-1767. It is, of course, immaterial whether such depreciation or depletion is subtracted from cost or added to selling price; in either event it increases the profit. Where a flat occupied in part by the owner is sold, cost must be reduced only by depreciation sustained on the portion used for rental purposes (O. D. 1026, T. B. 37-21-1810). Inasmuch as no deduction for depreciation of a personal residence is allowable, a taxpayer in determining the gain or loss arising from the sale of his personal residence, continuously occupied by him as such, is not required to reduce the cost of the property or its fair market value as at March 1, 1913, by the depreciation sustained. (O. D. 600, T. B. 30-20-1085, A. R. R. 249, T. B. 34-20-1168.)

[28] O. D. 945, T. B. 24-21-1682.

[29] O. D. 746, T. B. 50-20-1339.

profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.[30]

Selling Price. A sale of property usually involves the payment of cash in whole or in part therefor. The statute, however, taxes income from dealings in property as well as sales thereof, and reaches transactions such as exchanges of property, which, in effect, may be sales for a consideration in the equivalent of cash. In a sense, property received in exchange for other property constitutes a selling price other than cash, and in such cases the determination of the amount thereof and the gains, profits or income of the vendor, if any, presents the difficulties discussed in the following paragraphs.

Market Value. It has been indicated that in many instances when property acquired prior to March 1, 1913, is disposed of, its "fair market price or value" on that date is to be taken in lieu of cost in determining the gain derived, or the loss sustained, from the transaction. Again, when property is disposed of, the owner may not receive cash; the consideration may be, in whole or in part, other property. In other words, the transaction may constitute, in whole or in part, an exchange of property for property. Particularly is this true in regard to the organization and reorganization of corporations. In such cases the selling price of the property sold was, under the 1918 Law, the "fair market value, if any," of the property received.[31] In transactions involving the sale or disposition of property, sometimes referred to as capital transactions, the determination of the gain derived or the loss sustained may, then, require the determination of the "fair market price or value" on March 1, 1913, of the property sold. Under the 1918 Law it might require the determination of the "fair market value, if any" of the property received as of the date of the transaction. Under the present law it may require the determination of the "readily realizable" market value of the property received as of the date of the transaction.[32]

[30] Reg. 45, Art. 39, as amended by T. D. 3206, T. B. 33-21-1767.

[31] Revenue Act of 1921, § 202 (c); Revenue Act of 1918, § 202 (b).

[32] The market price or value of property on given dates is material in other connections. In the case of property acquired before March 1, 1913, the market value of the property on that date is the basis or capital sum for purposes of depreciation or depletion. (Revenue Act of 1921, §§ 214 (a) 8, 10, 234 (a) 7, 9; Reg. 45, Arts. 161 and 201.) Likewise, where the property is purchased for stock, the market value of the stock paid for it at the time of the purchase constitutes its cost for purposes of depreciation and depletion (Reg. 45, Art. 167). Services may be paid for with stock,

These considerations indicate the importance of a careful analysis of the term "fair market price or value" and "fair market value, if any," and the kind of evidence by which such market values may be established.

It will be noted that when establishing a basis for calculating the selling price equivalent of property sold or disposed of, the Revenue Act of 1918 used the expression "fair market value, if any."[33] When referring to the basis for computing the profit derived or loss sustained on property acquired prior to March 1, 1913, both that statute and the present law use the expression "fair market price or value."[34] The treasury department contends that the word "price" is narrower in its scope than the word "value".[35] It has nowhere, however, given emphasis to the expression "if any", the force of which will be discussed below. Irrespective of these differences of phraseology, there is a fundamental distinction between the purposes underlying the determination of fair market value in the two instances. When property is exchanged for other property, the property received may or may not be such as to give rise to income within the meaning of the statute and Constitution. It is admitted even by the treasury department that cases may exist in which property may have no fair market value so as to constitute taxable income.[36] On the other hand, it is admitted by the treasury department and well settled by the decisions that in ascertaining the gain or loss resulting from a sale or other disposition of property, the purpose of valuing such property on March 1, 1913, is to determine the amount which must be withdrawn from the selling price in order to keep the capital intact and that it would be necessary so to withdraw the value of the property on March 1, 1913, even if there were no statutory

which raises question of the market value of the stock (which constitutes income to the recipient) at the time of receipt. (See Chapter 15.) Under the Excess-Profits Tax Law, where tangible property is acquired from a stockholder as a gift or at a value in excess of the consideration paid therefor, the amount of the excess is deemed to be paid-in surplus; and when the actual cash value of tangible property exceeds the par value of the stock issued therefor, the excess over such par value may be treated as paid-in surplus. (Revenue Acts of 1918 and 1921, § 326 (a) (2), Reg. 45, Art. 837.) The calculation of this paid-in surplus necessitates the valuation of such tangible property at the date of acquisition. For cases illustrating these several connections in which the market value of property becomes important see: O. D. 1008, T. B. 35-21-1788; O. D. 1064, T. B. 42-21-1868.

[33] Revenue Act of 1918, § 202 (b).

[34] Revenue Act of 1918, § 202 (a).

[35] T. B. R. 57, T. B. 19-19-494.

provision therefor.[37] This would argue greater necessity for determining some market value as of March 1, 1913, for the property disposed of than for determining market value as of the date of the transaction for the property received. In other words, it may well be that for purposes of a valuation as of March 1, 1913, Congress intended that the phrase "fair market price or value" be given a much broader meaning than the phrase "fair market value, if any," which was used with reference to property received in an exchange of property for property.

"FAIR MARKET VALUE, IF ANY." Passing first to a definition of the phrase "fair market value, if any," it will be noted that the 1918 Law provided: "When property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any * * * ."[38]

Interpreting this provision the treasury department ruled as follows: "Gain or less arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of, and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized."[39]

This regulation was an admission in general terms of the principle which should control in determining whether an exchange of property for property was a "closed transaction" and resulted in taxable income or deductible loss under the 1918

[36] T. B. R. 57, T. B. 19-19-494; Reg. 45, Art. 1563, and Art. 1564, as amended by T. D. 3206, T. B. 33-21-1767.

[37] T. B. R. 57, T. B. 19-19-494; Doyle v. Mitchell, 247 U. S. 179; Lynch v. Turrish, 247 U. S. 221; Southern Pacific Co. v. Lowe, 247 U. S. 330. This is important. It means that the term "fair market price or value" as used in subdivision (a) 1 of § 202 adds nothing to the common law rule founded on the Constitution. If this is true, the meaning of the term as used in the statute is of little moment.

[38] The statements contained in the text above are illustrated by the distinction in phraseology contained in the present law between a reference to the value on March 1, 1913, of property exchanged and the value on the date of acquisition of property received. In the former case the 1921 Law uses the same expression as the 1918 Law ("fair market price or value"); in the latter case it uses the expression "readily realizable market value." Revenue Act of 1918, § 202 (b).

[39] Reg. 45, Art. 1563.

Law. For the present the discussion will ignore the question whether there has been "a change in substance and not merely in form"[40] and will refer to the question whether there has been a change "into the equivalent of cash," which underlies the discussion of the term "fair market value, if any." In other words, in providing that the property received shall be treated as the equivalent of cash to the extent of the amount of its "fair market value, if any," the 1918 Law clearly contemplated that the term "fair market value" should be used as a test to determine whether property was the "equivalent of cash." It is just as true to say that property has no fair market value if it is not the "equivalent of cash" as to put the statement in converse form.

Following the interpretation by the treasury department just quoted, in its most general statement regarding the meaning of the term "market value", the department made no distinction between the meaning of the term as used or contemplated in the various parts of the Revenue Act of 1918.[41] The statement was as follows: " * * * the fair value of the property in money as between one who wishes to purchase and one who wishes to sell. It is not, however, what can be obtained for the property when the owner is under peculiar compulsion to sell or the purchaser to buy; nor is it a purely speculative value which an owner could not reasonably expect to obtain for the property although he might possibly be fortunate enough to do so. 'Market value' is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price."[42] These definitions and interpretations were so general, however, that they help very little in a determination of any specific question. Was "fair market value" intended to be equivalent to "intrinsic value" which attaches to all property, or did it mean value as established upon an exchange, or something between these two extremes? The treasury department admitted the general proposition that property may be received upon an exchange which has no "fair market value" and is not equivalent to cash.

[40] For instance, an exchange of a stock certificate for a voting trust certificate does not produce income because the conversion is merely in form. Questions as to whether a conversion has been more than formal are usually raised in connection with the organization and reorganization of corporations and the subject will be discussed below under that heading.

[41] There is obviously such a distinction under the present statute.

[42] T. B. R. 57, T. B. 19-19-494.

For instance, it was ruled that stock in a "small, closely held corporation" was not the equivalent of cash if the stock has no market value, which, of course, implies that the stock of small, closely held corporations may have no market value.[43] On the other hand, in another ruling, although reiterating the rule that property received upon an exchange may have no "fair market value," the department held that in determining whether property has a "fair market value" all available evidence must be considered; that a case in which property has no "fair market value" should be regarded as "unusual" and a determination that the property has no "fair market value" should not be made "lightly"; that property is not without "fair market value" merely because there is a considerable divergence of opinion as to its value. The department took the view that property had no "fair market value when market conditions were such that there *would be* no trading in the property in question at a fair price."[44] The force of the words "would be" is to be noted. They required the taxpayer to prove not that there *was* or *had been* no trading or other evidence of value, but that there *would be* none if the property were put up for sale. The department refused to admit that property has no fair market value when there was "no price therefor established by public sales or sales in the way of ordinary business"; it held that the fact that there is no market price or current price so established did not indicate that the property might not be readily sold at a fair price.[45] Again, although the department admitted that stock in a small, closely held corporation might have no "fair market value," it held that stock in such a corporation "does not *ipso facto* lack 'a fair market value' " because "evidence as to the assets and liabilities of such a corporation and as to its earnings may furnish very definite indications as to its 'fair market value'."[46]

When the assets and liabilities and earnings of a corporation are resorted to in order to obtain the value of the stock of such corporation, the result reached constitutes the "intrinsic" value

[43] See Reg. 45, Art. 1563.

[44] T. B. R. 57, T. B. 19-19-494.

[45] T. B. R. 57, T. B. 19-19-494.

[46] T. B. R. 57, T. B. 19-19-494. This ruling went on to state: "Even if a corporation is newly organized and has never done business as such, but has succeeded to the business of an individual or partnership, its stock will ordinarily have a 'fair market value' ascertainable by reference to it assets and liabilities, the history of the specific business, and the history and conditions of the industry in general."

of such stock.[47] Although professing the general principle that property might have no "fair market value," the treasury department ruled, under the 1918 Law, that intrinsic value might be resorted to, if not as equivalent to market value, at least as indicative of market value.[48] And intrinsic value is so taken not as evidence of a market value which has existed or which is proved by past or present transactions; it is taken to indicate an hypothetical or potential market value—that is, what the property exchanged would bring *if* it were put up for sale. While there are numerous authorities defining market value in such a way as to include intrinsic value when there is no evidence of actual sales or dealings in the property involved, it is to be noted that these authorities deal with cases in which by reason of some accomplished fact or peculiar circumstances it is essential to make a fair valuation. In other words, the court was required to value the property involved in order to do equity in the situation at bar.[49] There are authorities, however, making it clear that there is a popular distinction between "market" and "intrinsic" value.[50] In using the expression "fair market value,

[47] The Standard Dictionary defines the word "intrinsic" as follows: "Pertaining to the nature of a thing or person; not simply apparent or accidental; inherent; real; true; as, the intrinsic value of a bronze medal is small." The meaning of the word "intrinsic" is illustrated by the following quotation from Virginia v. West Virginia, 238 U. S. 202: "The fact, however, that there was no sufficient proof of market value, was not an insuperable obstacle to the making of a fair valuation. It was clearly proper to introduce evidence tending to show the intrinsic value of the shares * * * For this purpose, resort was had to corporate accounts and reports of the company's affairs." See O. D. 955, T. B. 26-21-1699.

[48] The department admits the distinction between the capital assets of a corporation and the valuation of shares owned by the shareholders in A. R. R. 33, T. B. 9-20-764 (see also T. D. 2979, amending Reg. 45, Art. 102), a distinction which indicates the danger of resorting to intrinsic value. The distinction between resorting to intrinsic value as indicative of, as distinguished from equivalent to, market value is more apparent than real. If it is to be resorted to as indicative of market value when no other evidence as to market value exists, it is in practical effect taken as the equivalent of market value.

[49] Thus in a condemnation case the complainant's property has been taken from him by virtue of the power of eminent domain. Justice requires that he be compensated and this necessarily involves the determination of the market value of the property condemned. Obviously, in such a case, the court is required to determine a value even if it is unable to do so by reference to actual sales or dealings in the same kind of property. (See North Amer. Tel. Co. v. Northern Pac. Ry. Co., 254 Fed. 417.)

[50] This is proved by the quotation in footnote 47 above, from Virginia v. West Virginia, 238 U. S. 202. See Henry v. North American Ry. Const. Co., 158 Fed. 79; Crichfield v. Julian, 147 Fed. 65; Industrial & General

if any," did Congress intend to include a value not established by any sales or dealings in the property subject to valuation and which could only be proved by speculation as to what the public *might* pay for the property in question? In answering this question it is necessary to keep constantly in mind the purpose of obtaining "fair market value, if any," when there has been an

Trust v. Tod, 180 N. Y. 215, 73 N. E. 7. See also O. D. 955, T. B. 26-21-1699 and O. D. 1064, T. B. 42-21-1868, in which the treasury department itself contrasts "market" and "intrinsic" value. It is expressed again, from a slightly different viewpoint in North Amer. Tel. Co. v. Northern Pac. Ry. Co., 254 Fed. 417, as follows: "The term 'market value', as the words fairly import, indicates price established in a market where the article is dealt in by such a multitude of persons, and such a large number of transactions, as to standardize the price. Proof of such a market value can only be made by one of the recognized methods of proving the price current in a market. Individual dealings are not competent to prove it. The term is, however, frequently used in a figurative sense, as meaning the fair or reasonable value of the property—that is, such value as the property would have if it were dealt in according to the practices of a market overt. This is the meaning which the term usually has when applied to real property. To prove market value when it is used in this secondary or figurative sense, it is proper to receive evidence of individual transactions, even offers made in good faith for property of like character, the nature of the property, its location, its rental value, the uses to which it can be put, and all the manifold elements which are admissible to show the fair and reasonable value of property which is not so traded in as to give it a market value in the primary sense of the term." It is argued by economists that there is no such thing as intrinsic value; that value is market value since nothing has any value except as related to other things in the mind of a buying public. This may be true economically, but it does not touch the question under discussion. We are dealing not with theories but a question of fact—what people mean by the words they use, however inaccurately they may use them from the economic standpoint. It is to be regretted that the Supreme Court did not pass expressly upon the subject matter of the above admission made by the solicitor-general. With regard to gains represented by a difference between selling price and value on March 1, 1913, in cases in which the selling price was less than purchase price, the admission of the solicitor was undoubtedly necessary, under the sixteenth amendment, because such a gain could not constitutionally be taxed. But the allowance of any deduction for loss is a matter in which Congress is not inhibited by any constitutional limitation, and to deny the deduction of losses represented by a difference between selling price and value on March 1, 1913, where the selling price was less than purchase price, is in effect, to neutralize a loss occurring after the incidence of the tax by an admittedly non-taxable gain accruing prior to the incidence of the tax. The 1918 law plainly stated that such a loss should be an allowable deduction and the plain terms of the statute, where no constitutional limitations intervene, should be respected, whatever the result. (See Chapter 47.) Under the 1921 Law the intention of Congress to follow the solicitor's admission is clear, but a provision of this law may not be used in interpreting a previous statute.

exchange of property for property. If the fair market value of the property exchanged is not obtained, the tax on the appreciation in value of the property to the date of the transaction is not evaded; it is only postponed. Eventually it must be paid.[51] As a general proposition the only question involved is *when* the tax shall be paid. The determination of fair market value refers merely to the *time* when the taxpayer shall pay tax upon the appreciation in value of his property. He is required to pay when he receives the "equivalent of cash." In the light of this purpose it may be doubted, particularly in view of the use of the words "if any", whether in the Revenue Act of 1918 Congress intended to ignore the popular distinction which has just been indicated between "market" or primary and "intrinsic" or secondary value. Under the broad definition of market value contained in some authorities there will be much property having a market value which is not the equivalent of cash. It would seem rather that when the question is a definition of the "equivalent of cash," the term "fair market value" must be construed in such a way as not to include a value which cannot be converted into cash.[52]

Even if this doubt be resolved in favor of the government,[53] it is apparent that the rulings referred to above render it practically impossible for the taxpayer to prove that property received upon an exchange has no "fair market value." Evidence of no sales or dealings in property does not prove absence of such value. The taxpayer has the burden of proving a negative, that there *would be* no fair market value, if he offered the property in question for sale. There are cases in which it might seem that although property has never been dealt in so that no market actually existed, the existence of a market in the potential sense was clear. In such cases the property received by the taxpayer upon an exchange is the "equivalent of cash," whether or not it has, technically, a "fair market value." But there are also cases in which it might be inconvenient at least

[51] Under the 1918 Law, the one exception to this rule is that if the taxpayer gives the property away or dies and the property is sold by his donees, heirs or legatees, such donees, heirs or legatees will escape tax upon the appreciation to the date when they receive the property. Under the present law a gift would not avoid the tax on property appreciation.

[52] There is nothing in the case of U. S. v. Phellis, 42 Sup. Ct. Rep. 63, conflicting with this suggestion. The stock distributed in this case was "marketable."

[53] It is a rule of statutory construction that taxing statutes are to be construed most strictly against the government and in favor of the taxpayer. (Gould v. Gould, 245 U. S. 151.)

for the taxpayer to offer the property involved for sale in order to prove that it had no market value. It would seem that in the ordinary case, property which has not been dealt in cannot be dealt in upon any reasonable basis. Business men are constantly trading in all sorts of property. The fact that they are not dealing in a particular kind of property is certainly an indication that the property has no "fair market value." The very necessity of resorting to evidence other than sales and dealings in the same kind of property to prove the value of property goes to indicate that the property is not the "equivalent of cash." In other words, the rulings issued under the 1918 law practically closed the door on the possibility of proving absence of "fair market value," by holding that the absence of sales or dealings in the property did not prove that there was no "fair market value." The fact that there were and had been no such sales or dealings should at least have been held to create a presumption that no "fair market value" existed.[54]

"READILY REALIZABLE MARKET VALUE." The 1921 Law provides that on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a "readily realizable market value."[55] The term "readily realizable market value" should be construed in the light of the definition given by the treasury department under the 1918 Law to the term "fair market value, if any." The general purpose of this new provision is to modify the "presumption in favor of taxation," which had existed under the 1918 Law (as interpreted by the Treasury Department).[56] In many cases arising under that law the taxpayer realized no funds with which to pay substantial taxes imposed upon a transaction by virtue of a technical construction of the statute. Obviously, the desire is to avoid this evil of taxing profits which, if they existed, have not in any true sense been realized. In other words, the present law recognizes the hardship and injustice of taxing profits not yet converted into any real cash equivalent. It should be noted, however, that the term "readily realizable market value" is somewhat vague, and the application of the term to each particular exchange of prop-

[54] The Finance Committee of the senate has expressed this most aptly in a few words, as follows: "The existing law makes a presumption in favor of taxation. The proposed act modifies that presumption * * * ." It may have been a more accurate statement, if the committee had said: "The existing law (as enforced by the department * * *)." It is a question whether the "existing" law was properly interpreted by the department.

[55] Revenue Act of 1921, § 202 (c).

erty will not be easy. The problem of taxing gains derived upon an exchange of property for property has by no means been solved. The present statute merely indicates a general intent to restrict taxable income upon such exchanges to income which has a real cash equivalent.

Fair Market Price or Value as of March 1, 1913.[57] The object of valuing property as of March 1, 1913, whether for purposes of determining the gain derived or the loss sustained upon a sale or disposal thereof, or for purposes of ascertaining a depreciation or depletion capital sum, is to determine the amount which must be regarded as capital to be withdrawn from the selling price or from gross income. It is necessary to value the property as of March 1, 1913, in order to segregate capital and income and to insure the exemption of the former from tax. This is a compelling reason for a valuation as of March 1, 1913, upon the basis of whatever evidence is available, whether it be of sales or actual dealings in the property involved or something less tangible and conclusive. However the rule may be with regard to the "fair market value, if any," of the selling price or consideration received upon disposal of property, where the underlying issue is merely whether the tax shall be paid at one time or another, it is clear that the "fair market price or value" of property as of March 1, 1913, contemplates a valuation upon the best evidence obtainable. It may be that there is nothing to show that market value as of March 1, 1913, is greater than previous cost; this does not alter the fact that if any evidence exists, even though it be of a less conclusive character than actual sales and dealings in the property, as to the "fair market price or value" of property as of March 1, 1913, that evidence should be employed in determining such value. In other words, income must be a thing sufficiently real to be capable of being taken out of a business without the impairment of capital. The exact point at which an impairment of capital begins is one that cannot easily be determined with precision and questions of doubt as between income and capital must be resolved in favor of capital.[58] If the impairment of capital is to be avoided, whether the question be one of determining the taxpayer's capital at the incidence of the tax with regard to the property disposed of or one of depletion or depreciation, all evidence of value as of March 1, 1913, must be resorted to and the term "fair market

[56] See footnote 54.

[57] This term is used in both the Revenue Act of 1921 and the Revenue Act of 1918.

[58] T. B. R. 48, T. B. 16-19-457.

price or value" as of that date cannot be so limited that it may be proved only by evidence of actual dealings in the property under consideration in a more or less active market.

Proof of Market Value. There are various methods of proving "market value" in the broad sense of that term. They are discussed below without reference to the distinction which may exist between the terms "fair market value, if any," as used in the Revenue Act of 1918, and "fair market price or value," as used in the Revenue Act of 1921 and the 1918 Law, and regulations issued thereunder. It should be observed at the outset that the fair market price or value of property on March 1, 1913, or any other date, is a question of fact to be established by any evidence which will reasonably and adequately make it appear.[59] None of the methods discussed below is to be regarded as exclusive; one or more of them may be used accordingly as evidence is available.

SALES OR ACTUAL DEALINGS IN SIMILAR PROPERTY. Probably the most reliable method of ascertaining the value of property is by reference to sales or actual dealings in similar property. This method is recognized by the Treasury Department, and wherever such evidence is available, it should be used to establish market value.[60] The use of market quotations, as established upon an exchange, is essentially a resort to sales or actual dealings in property as proof of value. Price current lists and trade journal quotations are also, within certain limitations, acceptable evidence of value.[61] Where this method is adopted, the sales

[59] Reg. 45, Art. 1561, as amended by T. D. 3206, T. B. 33-21-1767.

[60] See O. D. 7, T. B. 1-19-12; O. D. 995, T. B. 26-21-1699; A. R. R. 403, T. B. 10-21-1492; A. R. R. 33, T. B. 9-20-764; See forms A, N, O and T, in which the value of mines, oil and gas wells, and timber lands is to be established by reference, among other things, to sales of similar property; see also Reg. 45, Art. 1584, in which market value for purposes of inventories is to be established by current bid prices.

[61] Virginia v. West Virginia, 238 U. S. 202, 212; Cliquot's Champagne, 3 Wall. 114, 141; Fennerstein's Champagne (Fennerstein v. United States), 3 Wall. 145; Chaffee v. United States, 16 Wall. 516, 542; Sisson v. Cleveland & T. R. Co., 14 Mich. 489; Cleveland & T. R. Co. v. Perkins, 17 Mich. 296; Whitney v. Thatcher, 117 Mass. 523; Fairley v. Smith, 87 N. C. 367; State ex rel. Mosely v. Johnson, 144 N. C. 257, 56 S. E. 922, 929; Nash v. Classen, 163 Ill. 409, 45 N. E. 276; Washington Ice Co. v. Webster, 68 Me. 449; Harrison v. Glover, 72 N. Y. 451. As a preliminary to their admission as evidence in the courts, such quotations must be accepted as trustworthy by the trade. Indeed, there are authorities which hold they are not acceptable without reference to the sources from which the quoted information is derived and some proof that the quotations are founded upon actual sales. (See Whalen v. Lynch, 60 N. Y. 468, at p. 474; Bunte v. Schuman, 46 Misc. 593; Fairley v. Smith, 87 N. C. 271; Norfolk & W. R.

or dealings in similar property offered as proof should bear some reasonable relation in volume to the amount of property being valued. It is well settled that when the market value of a commodity is in question, proof of such value must cover the range of the entire market and must not contemplate any sudden or transient inflation or depression of price resulting from independent sources.[62] Thus, the selling price of a few shares of stock is of little value in determining the actual worth of all the stock of a corporation.[63] It is also essential that the sales of similar property chosen as proof of market value on any given date should not be too remote in point of time from the date of valuation.[64]

APPRAISAL. The value of property as of a given date may be proved by an appraisal made by a disinterested person familiar with values of the kind of property in question and with conditions affecting such values at the time involved.[65]

ASSESSMENT FOR STATE TAX PURPOSES. The assessed value of property for purposes of state taxation constitutes evidence of the value of the property and may be used where the value of property is at issue for federal tax purposes.[66]

COST OR COST OF REPRODUCTION. Cost or cost of reproduction may be taken as evidence of value as of a given date.[67] If cost is taken, proper allowance must be made not only for depreciation, but also for appreciation, between the dates of acquisition

Co. v. Reeves, 97 Va. 284, 33 S. E. 606; Vogt v. Cope (Cal.), 4 Pac. 915; Fountain v. Wabash, 114 Mo. App. 676; Mt. Vernon Co. v. Teschner, 108 Md. 158; Doherty v. Harris, 230 Mass. 341.)

[62] Sutherland on Damages, Vol. 9, § 233; Todd v. Gamble, 148 N. Y. 382, 42 N. E. 982; Virginia v. West Virginia, 238 U. S. 202; Stein v. Hartshore, 123 App. Div. (N. Y.) 467. The phrase "in the volume in which ordinarily purchased" contained in Art. 1584 of Reg. 45 is an illustration of this rule. The implication contained in this phrase is clearly that a few isolated transactions in the commodity being inventoried would be inadequate proof of market value.

[63] Matter of Curtice, 111 App. Div. (N. Y.) 230, 97 N. Y. Supp. 444, affirmed 185 N. Y. 542, 77 N. E. 1184.

[64] Matter of Valentine, 147 N. Y. Supp. 231.

[65] O. D. 955, T. B. 26-21-1699. See also Forms A, N, O and T, in which the value of mines, oil and gas wells, and timber lands is to be established by reference, among other things, to sales of similar property.

[66] See Forms A, N, O and T, in which the value of mines, oil and gas wells, and timber lands is to be established by reference, among other things, to sales of similar property. This rule is applied when the fair market value of property as of the date of death of the owner is in question, and the property has been valued for purposes of a state inheritance tax. (Reg. 45, Art. 562.)

[67] T. B. R. 57, T. B. 19-19-494.

and valuation. The amount of appreciation is frequently the contested issue, however, and in such cases cost furnishes no guide in obtaining the desired result. Cost of reproduction may be largely a question of expert testimony.

CAPITALIZATION OF INCOME. Another test of the value of property is furnished by its capacity for producing income. Where the value of property is in doubt, the income produced by the property may be capitalized to obtain its value as of any given date. This method is most frequently used in valuing intangible property. There is no reason, however, why tangible property may not be valued similarly. For instance, real estate may be valued by capitalizing its rent producing capacity.[68]

PRORATING ON TIME BASIS. Under prior laws it has been the practice of the Treasury Department to require taxable profit to be determined by first ascertaining the difference between cost and selling price and then prorating the result according to the number of months the property was held before and after the incidence of the tax. The Supreme Court has referred to this method as a matter of detail to be settled according to the best evidence obtainable and in accordance with valid departmental regulations, and permitted the method to stand as applied in the case at bar.[69] While this method should be used only as a last resort, no reason appears why it is not acceptable in principle. Where the value of property is definitely known on two dates it is fair to assume that the appreciation or depreciation occurring between the two dates occurred evenly over the intervening period unless there is some direct evidence to the contrary, and if the difference is prorated on a time basis the value on the desired date is readily established.

BOOK VALUE. The value at which property is carried on the books of the owner is not conclusive evidence of its actual value. Where the government attempts to impose a tax upon the difference between book value and selling price, the taxpayer may show by other evidence the actual cost of the property or the actual value thereof at the incidence of the tax. Neither is the government bound by the value at which property is carried on the books of the owner.[70]

[68] A. R. M. 34, T. B. 10-20-777; O. D. 937, T. B. 23-21-1669. See Peo. ex rel. Ogdensburg Co. v. Pond, 13 Abb. N. C. (N. Y.) 1, appeal dismissed 92 N. Y. 643.

[69] Hays v. Gauley Mountain Coal Co., 247 U. S. 189. See also Great Northern Ry. Co. v. Lynch, T. D. 3147, T. B. 13-21-1532.

[70] Doyle v. Mitchell, 247 U. S. 179; U. S. v. Guggenheim Exploration Co., 238 Fed. 231; Forty Fort Coal Co. v. Kirkendall, 233 Fed. 704; State v. Lee (Wis.) 178 N. W. 471. For the practice under the 1909 Law in re-

Miscellaneous Evidence of Value. In addition to the methods set forth in the preceding paragraphs there may be other evidence in any particular case of a more or less general character indicating or throwing light upon market value. The value of property may be indicated in the course of litigation affecting the property, such as a partnership accounting or a partition action or the administration of an estate. It may be indicated in reports to stockholders of a corporation. The history surrounding any property under valuation, in the case of real property or oil lands, its geographical situation and the availability of a market, the question of transportation facilities, the security of the owner's title, may all affect the property's value. It is impossible to enumerate or classify finally the evidence which may be used to establish market value. In each particular case the taxpayer should exhaust the evidence obtainable and his conclusion should be based on a thorough consideration of all factors that may be evidential of the value in question.

Proof of the Market Value of Stock. It has been held that the value of shares of stock on March 1, 1913, should be determined upon the basis of market quotations as of that date and not upon the basis of book values.[71] Where the market quotations vary on the date of valuation the average price for the day should be taken.[72] In valuing securities as of March 1, 1913, the item of good-will indicated by a sale of all the stock of the corporation in 1916 should be valued as of March 1, 1913, by the application of the capitalization percentage based on earnings attributable to good-will.[73]

Shares of Same Stock Bought at Different Prices. When various parcels of stock of the same issue are bought and sold on different dates and at different prices, the shares sold should be identified, if possible, by the numbers of the certificates covering them, and the cost of the identical shares should be deducted in order to determine the profit. Where it is impossible to

gard to book entries, see T. D. 2130, and Great Northern Ry. Co. v. Lynch, U. S. Dist. Ct., Dist. of Minn., T. D. 3147, T. B. 13-21-1532.

71 A. R. R. 33, T. B. 9-20-764. For the distinction between the value of the capital assets of a company and the valuation of the shares owned by the shareholders, see People v. Coleman, 126 N. Y. 433, 27 N. E. 818.

72 Letter from treasury department dated November 2, 1916; I. T. S. 1919, ¶ 1857.

73 A. R. R. 252, T. B. 34-20-1143. In this case the treasury department rejected the contention that the amount received for good will in 1916 should be treated as having ratably accrued over the entire period of existence of a corporation from its organization to the date of sale.

identify the shares in this manner, the shares should be considered to be sold in the order in which they were purchased, that is, the cost of the first shares purchased should be deducted from the selling price of the first shares sold.[74]

Proof of Value of Intangible Property. Intangible property is frequently sold and its value on a given date then becomes the subject of valuation. The intangible property referred to includes patents, copyrights, secret processes and formulae, good-will, trade-marks, trade-brands, franchises and other like property.[75] Good-will has been defined by the Treasury Department as having "not merely the narrow and technical meaning which has attached to it in numerous court decisions," but as including that intangible value "which always attaches to a more than usually profitable enterprise by reason of its proven earning capacity."[76] Any profit or loss resulting from a sale of good-will can be taken only when the business, or a part of it, to which the good-will attaches is sold, in which case the profit or loss will be determined upon the basis of the cost of the assets, including good-will. If the good-will was acquired prior to March 1, 1913, the taxable gain or deductible loss should be ascertained in accordance with the rule stated above.[77] If nothing was paid for good-will acquired after February 28, 1913, no deductible loss with respect thereto is possible, although on the other hand, upon the sale of the business there may be a profit. It is immaterial that good-will may never have been carried on the books as an asset. The burden of proof is on the taxpayer to establish the cost or fair market value on March 1, 1913, of the good-will sold.[78] No depreciation can be deducted from gross income with respect to good-will, but amounts deducted on account of depreciation of patents or copyrights since February 28, 1913, or since the date of acquisition if subsequent thereto, must be added to profit or deducted from loss, as the case may be, in determining the gain or loss on a sale of patents or copyrights.[79]

No specific rule can be laid down for determining the value of intangible property which would be applicable in all cases and under all circumstances. The committee on appeals and re-

[74] Reg. 45, Art. 39, as amended by T. D. 3206, T. B. 33-21-1767. Letter from treasury department dated February 26, 1916; I. T. S. 1918, ¶¶ 413 and 1343; Reg. 45, Art. 36.

[75] See Revenue Act of 1918, § 325 (a).

[76] A. R. R. 252, T. B. 34-20-1143.

[77] See p. 428.

[78] Reg. 45, Art. 41, as amended by T. D. 3206, T. B. 33-21-1767.

[79] Reg. 45, Art. 40, as amended by T. D. 3206, T. B. 33-21-1767.

view, however, has suggested several methods of valuing good-will which, while not to be regarded as controlling, may serve to guide the taxpayer in valuing intangibles. It has been the practice of distillers and wholesale liquor dealers to put out under popular brands only so much goods as could be marketed without affecting the established market price therefor and to sell other goods of the same manufacture, age and character under other brands or no brand at all at figures below those which the well-known brands commanded. In such cases the difference between the price at which whiskey was sold under a given brand name and also under another brand name, or under no brand, multiplied by the number of units sold during a given year gives an accurate determination of the amount of profit attributable to that brand during that year, and where this practice is continued for a period long enough to show that this amount was fairly constant and regular and might be expected to yield annually that average profit, by capitalizing this earning at the rate, say, of 20 per cent., the value of the brand is fairly well established.

Another method is to compare the volume of business done under the trade-mark or brand under consideration and profits made, or by the business whose good-will is under consideration, with the similar volume of business and profit made in other cases where good-will or trade-marks have been actually sold for cash, recognizing as the value of the first the same proportion of the selling price of the second, as the profits of the first attributable to brands or good-will, is of the similar profits of the second.

The third method is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10% upon the average tangible assets for the period.[80] The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the committee that this return should be capitalized upon the basis of not more than five years' purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles. In applying this method, individuals or partnerships in determining net earnings should deduct a reasonable amount on account of the salaries of owners actively engaged in the business.[81]

[80] The 10% should be applied only to the tangible assets entering into net worth including accounts and bills receivable in excess of accounts and bills payable (A. R. M. 68, T. B. 28-20-1048).

[81] O. D. 937, T. B. 23-21-1669.

The foregoing is intended to apply particularly to businesses put out of existence by the prohibition law, but will be equally applicable so far as the third formula is concerned, to other businesses of a more or less hazardous nature. In the case of valuation of good-will of a business, which consists of the manufacture or sale of standard articles of everyday necessity not subject to violent fluctuations and where the hazard is not so great, the Committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10 to 8 or 9% and that the percentage for capitalization of the return upon intangibles might be reduced from 20 to 15%.

In any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it, and therefore a representative period should be used for averaging actual earnings, eliminating any year in which there were extraordinary factors affecting earnings either way. Also, in the case of the sale of good-will of a going business the percentage rate of capitalization of earnings applicable to good-will shown by the amount actually paid for the business should be used as a check against the determination of good-will value as of March 1, 1913, and if the good-will is sold upon the basis of capitalization of earnings less than the figures above indicated as the figures ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.[82]

A contemporary sale of stock will be considered as having greater weight in determining the value of a corporation's assets, including good-will, as of March 1, 1913, than values based on appraisal."[83]

Exchange for Different Kinds of Property. Where property is exchanged for other property which has no "readily realizable market value," together with money or other property which has a "readily realizable market value," the money or the fair market value of the property having such "readily realizable market value" received in exchange should be applied against and reduce the basis for determining gain or loss provided in the Revenue Act of 1921 of the property exchanged. If such money or the fair market value of other property having a "readily realizable market value" is in excess of such basis, such excess is taxable income. The basis so reduced will then be used in determining the gain derived or loss sustained upon a subsequent disposition of the property received which has no "readily realiz-

[82] A. R. M. 34, T. B. 10-20-777; A. R. R. 252, T. B. 34-20-1143.
[83] O. 791, T. B. 1-19-22.

able market value." If the property having a "readily realizable market value" is in excess of such basis, then the entire proceeds realized upon a subsequent disposition of the property having no "readily realizable market value" will be taxable income.[84]

RULE UNDER 1918 LAW. If property was exchanged for two different kinds of property, such as bonds and stocks, the bonds having a market value and the stock none, the value of the bonds was to be compared with the cost. If the market value of the bonds was less than such cost the difference represented the cost of the stock. If the market value of the bonds was greater than such cost, the difference represented gain and was taxable at the time of the exchange unless the original property was acquired prior to March 1, 1913, in which case the amount of gain taxable was computed in accordance with the rule stated above.[85] In either case the entire proceeds of such stock was taxable. If property was exchanged for two different kinds of property, such as bonds and stocks, neither having a fair market value, the cost of the original property was required to be apportioned, if possible, between the bonds and stock for the purpose of determining gain or loss on subsequent sales. If no fair apportionment was practicable, no profit on any subsequent sale of any part of the bonds or stock was realized until out of the proceeds of sales the entire cost of the original property had been recovered.[86]

Organization, Reorganization, Merger and Consolidation of Corporations. The present law in practical effect eliminates the element of taxable profit and deductible loss upon the reorganization merger and consolidation of corporations, and also upon the organization of a corporation where the stock of the corporation received by the former owners is distributed in substantially the same proportion as the former interests of such owners and the former owner or owners control the corporation. The purpose of these provisions was to "permit business to go forward with the readjustments required by existing conditions."[87] This purpose and the urgent necessity for amendment of the Revenue Act of 1918 in these respects will clearly appear from the discussion contained in succeeding paragraphs on the provisions of that statute bearing upon the organization and reorganization of cor-

[84] Revenue Act of 1921, § 202 (e).

[85] See p. 428.

[86] Reg. 45, Art. 1565, as amended by T. D. 3206, T. B. 33-21-1767.

[87] See Report of Finance Committee on Internal Revenue Bill of 1921, p. 11; Report of Ways and Means Committee, p. 10.

porations. The general rule under the Revenue Act of 1921 is that on an exchange of property for other property having a "readily realizable market value" a gain may be derived or a loss sustained. But even if the property received in exchange has a "readily realizable market value" no gain or loss will be recognized when in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as thus used, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected).

Neither will any gain or loss be recognized under the Revenue Act of 1921 when (a) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (b) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both received by such persons are in substantially the same proportion as their interests in the property before such transfer. A person is, or two or more persons are, "in control" of a corporation when owning at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation. Where property is exchanged for other property and no gain or loss is recognized, the property received will be treated as taking the place of the property exchanged therefor.

When money or other property of "readily realizable market value" is received upon the organization or reorganization (as above defined) of a corporation, other than stock or securities in a corporation a party to or resulting from such reorganization or the corporation organized as indicated above, the money or the fair market value of such other property received in exchange will be applied against and reduce the basis for determining gain or loss, provided by the Revenue Act of 1921, of the property exchanged, and if in excess of such basis, will be taxable to the extent of the excess.[88]

[88] Revenue Act of 1921, § 202.

Reorganization, Merger, Consolidation of Corporations Under the 1918 Law.[89] When property was exchanged for other property, the property received in exchange was treated, for the purpose of determining gain or loss, under the 1918 Law, as the equivalent of cash to the amount of its "fair market value, if any"; but when in connection with the reorganization, merger, or consolidation of a corporation a person received in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss was deemed to occur from the exchange, and the new stock or securities received were treated as taking the place of the stock, securities, or property exchanged. When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received was in excess of the aggregate par

[89] The provision discussed in this paragraph was perhaps the most artificial and illogical provision contained in the Revenue Act of 1918. It made the par value of stock a test of taxability. Par value has no relation whatever to actual value, as is well stated by the Supreme Court in Virginia v. West Virginia, 238 U. S..202, as follows: "Statements may be found to the effect that par value is prima facie actual value (citing cases), but if such statements can be deemed to announce a comprehensive rule, to be applied in the absence of evidence as to the property and business of the corporation, we cannot regard it as well founded. There is no such presumption of law, and common experience negatives rather than raises such an inference of fact. We took this view in Fogg v. Blair, 139 U. S. 118, 127, 35 L. Ed. 104, 107, 11 Sup. Ct. Rep. 476, when we criticized the supposition 'that the court, in the absence of averment or proof to the contrary, would assume that it (stock) was worth par, or had substantial value.' (Citing cases). Shares represent the proportionate interest of the shareholders in the corporate enterprise, and a rule that this interest, in the absence of all supporting evidence, should be taken as actually worth the par of the shares, would be wholly artificial. There is no exigency in the administration of justice which requires or justifies such an extreme assumption." Insofar, however, as the provision served to permit reorganizations, mergers and consolidations to be effected without precipitating tax liability, it served a useful purpose. The hardship of imposing a heavy tax in connection with reorganizations, mergers and consolidations is now recognized in the Revenue Act of 1921. Such proceedings frequently leave the taxpayer with pieces of paper representing precisely the same property, or interest in property, he had before. Only in a highly technical sense—that is, by virtue of the doctrine of separate corporate entity—can it be said that he has anything different. There has been merely a formal exchange; substantially he has the same property. The doctrine of separate corporate entity is discussed in Chapter 10 footnote 55 as applied to the organization of corporations and what is said there is equally applicable here. It should also be observed in this connection that the 1918 Law implied as a condition to taxability that the new stock or securities should have a "fair market value." This introduces the question discussed above as to the definition of the term "fair market value." (See p. 419.)

or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received was treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value was treated as a gain to the extent that "*the fair market value*" of the new stock or securities was greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.[90]

[90] Revenue Act of 1918, § 202 (b). The provisions of this section apply only to the determination of gain or loss from exchanges of stock in connection with reorganizations, consolidations or mergers occurring in 1918, 1919 and 1920. (O. D. 783, T. B. 5-21-1414; A. R. R. 156, T. B. 26-20-1024.) The original rulings of the treasury department were to the effect that upon a reorganization, where a new corporation was formed with a larger par value, the transfer of the assets from the old to the new and the exchange of stock by the stockholders of the old for a greater par value of stock of the new, did not create taxable income. (Letter from treasury department dated May 3, 1915; I. T. S. 1918, ¶ 1292; Letter from treasury department dated April 1, 1915; I. T. S. 1918, ¶ 398.) In the latter ruling it was said: "In this transaction there is nothing to indicate that the two shares of stock in the B Company of a par value of $100 each, had a value in cash or its equivalent in excess of the value of the stock in the A Company. There is no evidence other than the difference in the quantitative par value of the shares of stock, that any gain, profit or income was realized from the exchange of the shares of stock. It is, therefore, the opinion of this office that no accounting of income will be required until such time as the individual in question sells the stock of the B Company at a price in excess of the capital which he originally invested in the stock of the A Company." Where, upon a reorganization, new stock was acquired by a stockholder in exchange for old stock, and both were of the *same par value*, no income arose at the time of the exchange, but when the new stock was sold, the gain was required to be based upon the cost of the old stock, or its value as of March 1, 1913. (Letter from treasury department dated March 8, 1917; I. T. S. 1918, ¶ 1302.) Where upon a reorganization stock of the new company was issued in exchange for shares of the old, the new company taking over the property of the old, no income accrued if the exchange of stock was share for share of like par value, even though the property of the first corporation had increased in value over a period of years since its stock was first issued. Where the stock of both corporations was of like par value and predicated upon exactly the same assets the transaction resulted in no gains, profits, or income to either the first corporation or its stockholders. If the stock of the first company at the time of the transaction was worth "double par," the stock of the second company, being supported by identically the same assets, was presumably of the same value, and the exchange of the new stock for the old resulted in no income. It was simply an exchange of assets of like character and like value. (Letter from treasury department dated March 8, 1917; I. T. S. 1918, ¶ 1302.) Where the assets of one corporation were transferred to another, the stockholders of the first receiving in exchange for their stock a *greater amount of stock*, par value, in the new corporation, the

DEFINITION. The phrase "aggregate par value" meant the aggregate par value of stock of each individual stockholder, exchanged for new stock and the aggregate par value of such stock

par value of the new stock was considered as the equivalent of cash and taxable to the extent that it exceeded the cost of the old. Where the stockholders of a corporation surrendered their stock for stock of less par value, they were permitted to claim a loss on the difference between the cost of the old and the par of the new. (Letter from treasury department dated March 9, 1917; I. T. S. 1918, ¶ 3222.) In later rulings, however, it was held that, upon a reorganization, where a new corporation was formed with a stock of larger par value, the transfer of assets of the old to the new and the exchange of stock by the stockholders of the old for stock of a greater par value of the new created income to the old corporation and its stockholders; but that in determining the amount of such income, or the "amount received" by the old corporation and the "amount distributed" to its stockholders, the par value of the stock of the new corporation would only be taken as the actual value, or an equivalent of cash, "in the absence of any proof to the contrary." In other words, although the transaction was still held to be a closed and completed one, the conclusive presumption, that the par value of the stock of the new corporation represented actual value and was the equivalent of cash, was reduced to a rebuttable presumption; and the value of such stock became a matter of proof, or question of fact. (Letter from treasury department dated November 10, 1917; I. T. S. 1918, ¶ 1309; letter from treasury department dated December 8, 1917; I. T. S. 1918, ¶ 1313; letter from treasury department dated March 19, 1918; I. T. S. 1918, ¶ 3222; Reg. 33 Rev., Art. 101. The Supreme Court has definitely held that par value is not even prima facie evidence of actual value (Virginia v. West Virginia, 238 U. S. 202, 219). The treasury department next drew a distinction between reorganizations involving the purchase of the *stock* and those involving the purchase of the *assets* of the old company. It was held that where a corporation acquired from stockholders the *stock* of another corporation, giving in exchange therefor its own stock, the transaction was one by which the corporation acquiring the stock became the sole stockholder of the other corporation and that no income accrued to the corporation whose stock was thus acquired. This was true even though later the holding corporation caused the assets of the underlying company to be transferred to it for mere nominal consideration. (Reg. 33 Rev., Art. 124.) It was held that if a corporation sold its *assets* in whole or in part and the purchase price was paid with stock issued by the purchasing company, the purchase price would be the actual value at the time of the stock issued in payment for such assets. (Reg. 33 Rev., Art. 101; letter from treasury department dated September 9, 1916; I. T. S. 1918, ¶ 1297.) If the shares of stock received by the selling corporation were distributed to its stockholders, the fair market value of the stock so distributed in excess of the cost (or fair market value as of March 1, 1913) of the stock held by them in the selling corporation would be considered income to the stockholders. (Letter from treasury department dated September 9, 1916; I. T. S. 1918, ¶ 1297; Reg. 33 Rev., Art. 101.) If the excess over value as of March 1, 1913, or over cost, as the case might be, included any surplus

received by each individual stockholder.[91] The word "or" as used in the phrase "stock *or* securities" was held to be synonymous with the word "and" and a person might, in connection with the reorganization, merger or consolidation of a corporation, turn in either stock or securities, or both, and accept either new stock or securities, or both, of no greater par or face value, without being liable for tax.[92] The term "reorganization" was held to mean a business arrangement whereby the stock and bonds of a corporation were readjusted as to amount, income or priority, or the issue of one kind of stock was substituted for the issue of another kind, or the property was sold to a new corporation for new stock and bonds, or was sold by foreclosure of a mortgage upon it to a purchaser who bought for himself and his associates, and included the various proceedings and transactions by which succession of corporations was brought about, and also the proceedings by which existing corporations were continued under a different organization without the creation of a new corporation.[93]

The term "reorganization" included cases of corporate adjustment where stockholders exchange their stock for the stock of a holding corporation, provided the holding corporation and the original corporation, in which it held stock, were so closely related that the two corporations were affiliated.[94] A merger of two or more corporations was defined as taking place when one of such corporations retained its corporate existence and absorbed the other or others, which thereby lost their corporate existence; a consolidation was defined as taking place when a new corporation was created to take the place of the constituent corporations which were themselves dissolved in the process.[95] "Par value" in foreign currency was required to be converted into United States currency at the rate of exchange prevailing on the date of a reorganization, consolidation or merger.[96]

EXCHANGE OF STOCK FOR OTHER STOCK OF NO GREATER PAR VALUE. In general, where two (or more) corporations unite

earned since March 1, 1913, by the selling company, upon which the income tax had been paid, the excess or profits resulting from the sale might be reduced by the amount of such tax-paid surplus.

[91] O. D. 204, T. B. 10-19-353.

[92] O. D. 335, T. B. 29-19-623.

[93] Reg. 40 Rev., Art. 33. See Cook on Corporations, 7th Edition, ¶ 883. This definition was made for stamp tax purposes. See U. S. v. Phellis, 42 Sup. Ct. Rep. 63.

[94] Reg. 45, Art. 1567. See U. S. v. Phellis, 42 Sup. Ct. Rep. 63.

[95] Sol. Op. 4, T. B. 22-20-981.

[96] O. D. 1058, T. B. 41-21-1589.

their properties, by either (a) the dissolution of corporation B and the sale of its assets to corporation A, or (b) the sale of its property by B to A and the dissolution of B, or (c) the sale of the stock of B to A and the dissolution of B, or (d) the merger of B into A, or (e) the consolidation of the corporations, no taxable income within the meaning of the 1918 Law was received from the transaction by A or B or the stockholders of either, provided the sole consideration received by B and its stockholders in (a), (b), (c), and (d) was stock or securities of A, and by A and B and their stockholders in (e) was stock or securities of the consolidated corporation, in any case of no greater aggregate par or face value than the old stock and securities surrendered. So-called "no-par-value stock" issued under a statute or statutes which require the corporation to fix in a certificate or on its books of account or otherwise an amount of capital or an amount of stock issued which may not be impaired by the distribution of dividends, was deemed to have a par value representing an aliquot part of such amount, proper account being taken of any preferred stock issued with a preference as to principal. In the case (if any) in which no such amount of capital or issued stock is so required, "no-par-value stock" received in exchange was regarded as having in fact no par or face value, and consequently as having "no greater aggregate par or face value" than the stock or securities exchanged therefor.[97]

A number of cases have arisen under the 1918 Law in connection with the reorganization, merger and consolidation of corporations in which the stockholders of the old corporation or corporations have been held free from tax on the ground that the aggregate par or face value of the stock or securities received was less than the aggregate par or face value of those exchanged. Each of these decisions is based upon its peculiar circumstances and should be used with caution in connection with any other case. In view of the importance of the subject the more important of these decisions are reviewed below:

1. The only requirement of the Revenue Act of 1918 was that the new securities received upon the reorganization, merger or consolidation of a corporation or corporations should have no greater face value than the old. The *actual* value of the respective securities was immaterial. The nature of the respective securities was also immaterial; either the old or new securities might be bonds or stock, or both.[98]

[97] Reg. 45, Art. 1567.
[98] T. B. R. 25, T. B. 6-19-267.

2. Where the stockholders of one of several banks which were consolidated received in exchange for their shares stock of the consolidated bank of no greater aggregate par or face value than their shares in the old bank, bonds purchased by the old bank subsequent to March 1, 1913, at 80 being taken over by the consolidated bank at 70 and later sold by the consolidated bank at 80, the department held that there was no realization of gain or loss at the time of consolidation by either the old bank or its stockholders, and also that the consolidated bank did not receive any profit on the sale of the bonds since it should have placed them on its books at the same figure at which they were carried by the old bank.[99]

3. Mere multiplication of the number of shares of a corporation (resulting from the exchange of four new shares, each having a par value of $25, for each old share of $100 par value) when not accompanied by conversion of surplus into capital stock or revaluation of assets, did not give rise to taxable gain or income to stockholders making the exchange. Where a corporation amended its charter so that instead of having 10,000 shares of no-par value, the same stockholders held 100,000 shares without par value, neither the original charter nor the amendment having any stated capital in dollars, this multiplication of shares being not accompanied by conversion of assets into capital stock or any revaluation of assets, such a transaction did not give rise to taxable income to stockholders making the exchange.[100] Likewise where a charter of a corporation is amended, and each stockholder receives no-par stock for par stock, share for share, no deductible loss is sustained even though the no-par stock is worth less, as proved by actual sales, than the cost or par value of the old stock.[101]

4. Where a corporation was insolvent and the bondholders bid in the property at foreclosure sale and for the purpose of reorganization conveyed it to a new corporation, receiving in exchange for their bonds stock of the new corporation of the same par value, the department held that a bondholder might deduct as a loss under the 1913 Law the amount by which the cost of the bonds, or their fair market value as of March 1, 1913, if acquired prior thereto, exceeded the fair market value at the time of the exchange of the stock received by him.[102]

[99] O. D. 418, T. B. 13-20-803.

[100] T. B. R. 39, T. B. 12-19-396.

[101] O. D. 1080, T. B. 44-21-1891.

[102] S. 1294, T. B. 4-20-698. In this case neither of the old insolvent companies had paid interest on their bonds for some years prior to the foreclosure and the bonds seemed to have depreciated in value by March 1,

5. In a case in which two existing corporations were consolidated under the act of General Assembly of the State of Ohio, by the exchange of no-par value shares of the new corporation for the entire assets and obligations of each of the existing corporations, which in turn were liquidated, it was held that the no-par value stock of the consolidated corporation would be deemed to have a par value represented by the aliquot part of the total book value of the properties of the corporations which were consolidated and exchanged for the no-par value shares. This decision was based upon the Ohio statute limiting the declaration of dividends to surplus profits arising from the business of a new corporation. Under this provision the net value of the assets of the corporations which were consolidated might not be less than the amount of capital stated in the articles of incorporation as that with which the new corporation was to carry on business. It was not required to be in excess of that amount. If in fact the net value of the assets of the corporations which were consolidated exceeded the amount of capital specified in the articles of incorporation, the excess was deemed paid-in surplus out of which dividends might be paid.[103]

Determination of Gain or Loss from Subsequent Sale. The new stock and securities received, when they are of no greater aggregate par or face value than the stock or securities exchanged, took the place, under the 1918 Law, of the old stock and securities. For the purpose, therefore, of ascertaining the gain derived or loss sustained from the subsequent sale of any stock of A or of the consolidated corporation, so received, the original cost to the taxpayer of the stock of B or A in respect of which the new stock was issued, less any untaxed distribution made to the taxpayer by A out of the former capital or surplus of B, or by the consolidated corporation out of the former capital or surplus of A or B, was the basis for determining the amount of such gain or loss. However, the gain which was taxable or the loss which was deductible in the case of the subsequent sale of any stock of A or of the consolidated corporation,

1913, practically to the extent of the value of the stock received by the bond-holders in the new corporation. The department consequently held that the taxpayer sustained no deductible loss in 1914 when the reorganization was effected. It will be noted that this case was decided under the 1913 Law which contained no provision that where upon the reorganization, merger or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss is deemed to occur from the exchange. (Revenue Act of 1918, § 202 (b).)

[103] Sol. Op. 72, T. B. 45-20-1286.

so received, when the stock of B or A in respect of which new stock was issued was acquired prior to March 1, 1913, was required to be determined in accordance with the rule stated above.[104] When securities of a single class were exchanged for new securities of the same total par value but of different classes, for the purpose of determining profit or loss on the subsequent sale of any of the new securities, the proportion of the original cost to be allocated to each class of new securities was that proportion which the market value of the particular class bore to the market value of all securities received on the date of the exchange. If the securities exchanged were acquired prior to March 1, 1913, the proportion of their value as of such date to be allocated to each class of new securities was that proportion which the market value of the particular class bore to the market value of all securities received on the date of the exchange and the gain or loss was required to be determined in accordance with the rule stated above.[105] For example, if 100 shares of common stock, par value $100, were exchanged for 50 shares of preferred and 50 shares of common each of $100 par value, and the cost of the old stock was $250 per share, or $2,500, but the market value of the preferred on the date of the exchange was $110 per share, or $5,500 for the 50 shares, and the market value of the common was $440 per share or $22,000 for the 50 shares of common, one-fifth of the original cost, or $5,000, would be regarded as the cost of the preferred and four-fifths, or $20,000, as the cost of common. The same method of computation was required to be used in the case of stock acquired prior to March 1, 1913, in order to ascertain the proportion of such value to be allocated to each class of new securities on that date and the taxable gain or deductible loss was required to be thereafter computed in accordance with rule stated above.[106] Similarly, the cost after reorganization, merger, or consolidation of the assets of A, or of the consolidated corporation, was the sum of the cost of the assets of A and B for the purpose of ascertaining the gain or loss from a subsequent sale. However, in case the assets were acquired prior to March 1, 1913, in order to compute the taxable gain or deductible loss, the fair market value as of such date was also required to be ascertained by taking the sum of the fair market value of the assets of A and B.[107]

[104] See p. 413.
[105] See p. 413.
[106] See p. 413.
[107] Reg. 45, Art. 1568, as amended by T. D. 3206, T. B. 33-21-1767.

EXCHANGE OF STOCK FOR OTHER STOCK OF GREATER PAR VALUE. If in the case of any reorganization, merger, or consolidation, the aggregate par or face value of the new stock or securities received was in excess of the aggregate par or face value of the stock or securities exchanged, income within the meaning of the 1918 Law would be realized from the transaction by the recipients of the new stock or securities to an amount limited by (a) the excess of the par or face value of the new stock or securities over the par or face value of the old, and (b) the excess of the fair market value of the new stock or securities over the cost of the old, unless the old stock or securities were acquired prior to March 1, 1913, and their fair market price or value as of that date was greater than their cost, in which case, the fair market value of the new stock or securities must be in excess of the fair market value as of March 1, 1913, of the old. The taxable profit was (a) or (b), whichever was less.[108] There was no election whether (a) or (b) applied. The fair market value of each stockholder's interest was required to be determined as of the date the reorganization, merger or consolidation was consummated, not the date on which the exchange of stock took place.[109]

In a number of cases involving the reorganization, merger or consolidation of corporations in which the aggregate par or face value of the stock or securities received exceeded the aggregate par or face value of the stock or securities exchanged, the stockholders of the old corporation or corporations were held liable to tax. Each of these decisions is based upon its peculiar circumstances and should be used with caution in connection with any other case. In view of the importance of the subject the more important of these decisions are reviewed below:

1. A company whose operations had proved very profitable was reorganized, two new corporations being formed, one to take over its production business and the other its pipe-line business. By the reorganization the stockholders of the old company came into the possession of stock of a holding company and the two reorganized companies and bonds of the two reorganized companies of a greater aggregate par or face value than their old stock. The beneficial interests in the enterprise remained the same. This transaction was held to produce taxable income to the stockholders of the old company.[110]

108 Reg. 45, Art. 1569, as amended by T. D. 3206, T. B. 33-21-1767.
109 O. D. 1071, T. B. 43-21-1880.
110 A. R. M. 67, T. B. 28-20-1049.

2. Where in connection with a reorganization of a company a stockholder had the right to make an exchange in one year, but did not *actually make* the exchange until the following year, the profit accruing was deemed income in the year in which the exchange was actually made.[111]

3. In a case decided under the Massachusetts statute the complainant was the owner of 2,300 shares of common and preferred stock of an ascertained value on January 1, 1916 (the date of incidence of the Massachusetts tax). In the following July she used this stock as consideration with which to subscribe for and acquire 4,125 shares of common stock in a new and different corporation formed to take over the assets of the old, the new stock having a greater total par value than the old. The new corporation became the owner of substantially all of the stock of the old company and caused to be transferred to itself all the assets of the old company and carried on the business of the latter through the same officers without interruption and without outward indication of change. The court held that the complainant was subject to tax on the difference between the value on January 1, 1916, of the stock of the old company and the market value of the stock of the new company at the time of transfer.[112]

4. Where in the case of a consolidation effected in 1920 the new stock received exceeded the old stock in par value, but its market value was less than the cost in 1918 of the stock exchanged, it was held that no deductible loss was sustained.[113] Where the market value of the stock received, taken together with certain cash received, was less than the cost of the old stock, it has been held that a deductible loss was sustained, even though the par value of the new stock exceeded the par value of the old stock.[114]

5. The members of a joint-stock company were held taxable when it reorganized into a corporation and the par value of the

111 A. R. R. 289, T. B. 44-20-1274.

112 Osgood v. Tax Commissioner, 235 Mass. 88, 126 N. E. 371. The court said: "Although the property owned by the new corporation was identical with that owned by the old corporation, it nevertheless plainly was a different legal entity * * * The stock obtained by the complainant through exchange was different in kind and not merely in degree from that which she owned before. It was not the same corporation and the stock itself was different in nature, a change of investment had been made both in name and essence." (See also Stone v. Tax Commissioner, 235 Mass. 93, 126 N. E. 373.)

113 O. D. 932, T. B. 22-21-1660.

114 O. D. 970, T. B. 28-21-1722.

stock received was greater than the par value of their respective interests in the joint-stock company.[115]

6. A case of great importance involving the reorganization of a corporation and arising under the 1913 Law has been recently decided by the Supreme Court.[116] The facts were briefly as follows:

A New Jersey corporation, having a large surplus sufficient to cover the distribution indicated below, transferred all its assets and good-will to a Delaware corporation which assumed all the obligations of the New Jersey corporation except capital stock and funded debt. The New Jersey company retained some cash to redeem one issue of mortgage bonds and with some of the debenture stock received from the Delaware company redeemed its preferred stock and another issue of bonds, the balance of debenture stock received being just equal to the outstanding common capital stock of the New Jersey company and being retained in the treasury of the New Jersey company. In addition to this debenture stock the New Jersey company also received an amount of common capital stock of the Delaware company with a par value of twice the outstanding common stock of the New Jersey company. Each common stockholder of the New Jersey company retained his common stock and received two shares of common stock of the Delaware company for each share held by him in the New Jersey company. Immediately after the reorganization the personnel of stockholders and officers of the two corporations was identical, and the common stockholders of each corporation had the same proportionate stockholding. The New Jersey company did not liquidate, but continued as a going concern, although it ceased doing business with the exception of the redemptions above indicated, the holding of the above debenture stock, and the collection and disposition of dividends thereon. The Commissioner held that the common stock of the Delaware company received by the common stockholders of the New Jersey company constituted income to such stockholders to the extent of its fair market value, which value was apparently not in dispute. The Supreme Court, reversing the court of claims, and sustaining the Commissioner, held: (a) The true inquiry must be whether the stock of the Delaware company received as a dividend by the stockholders of the New Jersey company constituted "a gain derived from capital, not a gain accruing to capital, nor a growth or incre-

[115] O. D. 1051, T. B. 40-21-1851.

[116] U. S. v. Phellis, 42 Sup. Ct. Rep. 63. See also Rockefeller v. U. S.; N. Y. Trust Co. v. Edwards, 42 Sup. Ct. Rep. 68.

ment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital invested, and coming in, that is, received or drawn by the claimant for his separate use, benefit and disposal." (b) The transfer of the New Jersey company's assets in exchange for stock of the Delaware company and the distribution of such stock among the stockholders of the New Jersey company changed the former situation materially; the stockholders of the New Jersey company received assets of exchangeable and actual value "severed from their capital interest" in the New Jersey company. Prior to the distribution the common stockholders of the New Jersey company had merely a contingent right to participate eventually in the accumulated surplus of that company; after the distribution they had new individual property rights which they severally were entitled to retain and enjoy or sell and transfer. In the language of the court, "whether he (the stockholder) sold the new stock for money or retained it in preference, in either case when he received it he received as his separate property a part of the accumulated profits of the old company in which previously he had only a potential and contingent interest". (c) A comparison of the market value of the stockholders' shares in the New Jersey corporation immediately before with the aggregate market value of the shares plus the dividend shares immediately after the transaction, as demonstrating that there was neither a pecuniary gain nor loss in the transaction, is immaterial. Any dividend or distribution, whether paid in money or assets, reduces the intrinsic value of the shares of stock to which the distribution or dividend appertains. (d) Looking through the substance of the entire transaction the Delaware company can not be regarded as identical with the New Jersey company, but must be treated as a substantial corporate body with separate entity. The new corporation was incorporated in a different state; it had a greater authorized capital stock; the identity of officers in the two corporations depended on the continued and unanimous consent or concurrent action of a multitude of individual stockholders actuated by motives and influences necessarily to some extent divergent; the identity of the stockholders was but a temporary condition subject to change at any moment at the option of any individual, and the very fact of the transfer of the assets by the one company to the other evidenced the actual separateness of the two companies.

7. In a case arising under the 1909 Law the defendant purchased in 1909 certain properties, the legal title to which was taken in the name of its president, as trustee. Later in the

same year, pursuant to a plan for increasing the capital stock of the defendant, these properties were conveyed by the trustee to a corporation which had been formed for the express purpose of thus acquiring and using them in carrying out the recapitalization scheme. The consideration of the conveyance was the issuance by the latter company to the trustee of practically its entire capital stock. The stock thus issued to the trustee was immediately transferred by him to the defendant, which, in turn, distributed it among its stockholders, share for share. Thereupon, in furtherance of the recapitalization plan, a merger was effected between the defendant and the new company. For purposes of the merger, the value of properties so conveyed to the new company (which constituted all of its assets) was fixed at the same figure as that at which the trustee had conveyed them to that company; also, before the stock was distributed among the defendant's stockholders, it was formally valued by its directors at par. The par value of such stock greatly exceeded the price at which the property had originally been purchased by the defendant. The defendant did not include as income in its return the apparent profit resulting from the difference between the price which it had originally paid for the properties and the price at which it had ostensibly sold them to the new company. The government took the position that the illegal profit—both the purchase and sale having taken place within the year 1909—was taxable income of that year under the 1909 Law, but the court held to the contrary.[117]

Determination of Gain or Loss from Subsequent Sale.

[117] Alpha Portland Cement Co. v. U. S., 261 Fed. 339. The court said: " * * * it is apparent that while, as a matter of form and of bookkeeping, the defendant did realize a very considerable profit during the tax year in question on the purchase and transfer of these properties, yet in reality it made no profit whatever. The ultimate and real result of the various transactions was that the defendant purchased some properties at one figure, and in working out a plan of recapitalization valued them at a higher figure. The intermediary corporation, to which the legal title of the properties was conveyed by the trustee, was brought into being by the defendant for the express purpose of working out the recapitalization plan, and ceased to exist as a separate entity after that plan had been carried out. The defendant was no richer after the alleged sale than it was before, notwithstanding the book entries, resolutions of directors, transfers of title, etc. Viewed in this light, we think that it needs no argument to demonstrate that the case falls within the principle of the decisions of the Supreme Court in Southern Pacific v. Lowe, 247 U. S. 330, 38 Sup. Ct. 540, 62 L. ed. 1142, and Gulf Oil Corp. v. Lewellyn, 248 U. S. 71, 39 Sup. Ct. 35, 63 L. ed. 133. Indeed, it cannot be distinguished on principle from the decision of this court in Baldwin Locomotive Works v. McCoach, 221 Fed. 59, 136 C. C. A. 660."

On a subsequent sale of the new stock or securities received when they were of greater aggregate par or face value than the stock or securities exchanged, the cost to the taxpayer of the new stock or securities was held to be the cost of the old stock or securities plus the profit taxed on the exchange.[118]

Exchange of Property for Stock. Where property was transferred to a corporation in exchange for its stock the Treasury Department held, under the 1918 Law, that the exchange constituted a closed transaction, that the former owner of the property realized a gain or loss if the stock had a market value and such market value was greater or less than the cost of the property given in exchange, but that if the property was acquired prior to March 1, 1913, the amount of taxable gain or deductible loss was to be determined in accordance with the rules stated above.[119] The definition of the term "market value," as used in this regulation, has been discussed above. The organization of a corporation furnishes one of the leading examples of ex-

118 Reg. 45, Art. 1569, as amended by T. D. 3206, T. B. 33-21-1767.

119 See p. 413; Reg. 45, Art. 1566, as amended by T. D. 3206, T. B. 33-21-1767. The provision of the 1921 Law upon this point has been discussed above. (See p. 446.) The conference committee struck out a provision of the senate report on the Revenue Act of 1918 to the effect that when a person or persons owning property received in exchange for such property stock of a corporation formed to take over such property, no gain or loss was to be deemed to accrue from the exchange and the new stock or securities received were to be treated as taking the place of the stock, securities, or properties exchanged. The treasury department first ruled that where property was transferred to a corporation in exchange for its stock, if the previous owner of the property received 50% or more of the stock of the corporation, so that an interest of 50% or more in such property remained in him, then no gain or loss was realized by such owner from the transaction. For the purpose of ascertaining the gain or loss from the subsequent sale by the stockholder of any stock so received for such property, the stock was to be considered as substituted for the property, and the cost of the property or (if acquired prior thereto) its fair market value as of March 1, 1913, was the basis for determining the amount of such gain or loss. For the purpose of ascertaining gain or loss from the subsequent sale by the corporation of any such property; the cost of the property to the former owner or (if acquired prior thereto by him) its fair market value as of March 1, 1913, was the basis for determining the amount of such gain or loss. If, however, the exchange of property and stock involved less than 50% of the stock of the corporation, such exchange constituted a closed transaction, and the former owner of the property was held to have realized a gain or loss if the stock had a market value and such market value was greater or less than the cost or (if acquired prior thereto) the fair market value as of March 1, 1913, of the property given in exchange. This ruling was later considered by the treasury department not to be warranted in law, and was modified to conform with the text above. (See T. D. 2924.)

change of property presenting the question as to what constitutes "fair market value, if any." Two questions are presented upon the organization of a corporation: (1) Has the property transferred to the corporation been converted into property essentially different from the property disposed of, and (2) has it been converted into property having "a fair market value." Has there been a change in substance as well as form, and a change into the "equivalent of cash"?[120] Unless the answer to both these questions is in the affirmative, the transaction was not "closed" within the meaning of the 1918 Law, and there was no taxable gain or deductible loss. If property was transferred to a going, established corporation having an active market for its stock and a small fraction of that stock was taken in payment thereof, the consideration undoubtedly should have been treated, under the 1918 Law, as the "equivalent of cash." It was convertible into money.[121] There was also a change in substance as well as form. On the other hand, where an individual transferred assets to a newly formed corporation in exchange for all its stock, it is equally apparent that he has not received the equivalent of cash. His stock was not convertible into money.[122] The department admitted that if a taxpayer exchanged property for stock in "a small, closely held corporation," no income was realized if the stock had no market value, but its definition (under the 1918 Law) of market value was so broad as to render it difficult to conceive of a stock which would not have market value.[123] In considering this question, it seems, moreover, that there has been some confusion between the two tests just indicated. In a case of the transfer of assets to a newly formed corporation in exchange for all of its stock, has there been a change in substance? The department's example of a change in form only was the case of a man owning 10 shares of listed stock exchanging his stock certificate for a voting trust certificate.[124] This was, of course, a conversion merely in form, but was it anything more than a formal conversion when an

[120] See Reg. 45, Art. 1563.

[121] See Tennant v. Smith, (1893) A. C. 150.

[122] The stock received might be valued on the basis of sales made soon after its receipt by the taxpayer, according to A. R. R. 156, T. B. 26-20-1024. The market value of the stock received should theoretically, at least, have been taken on the precise date when it is received. Certainly, the value should not be taken as of a later date if new factors have intervened between the date of receipt and the date of the dealings therein which affect such value.

[123] See p. 419.

[124] Reg. 45, Art. 1563.

individual transferred assets to a newly formed corporation in exchange for all of its stock? After the exchange he has pieces of paper representing exactly the same property he had before the exchange. The pieces of paper stand in the place of the property exchanged. Were these pieces of paper "*other* property," to use the words of the Revenue Act of 1918? In one sense, he was the corporation, in spite of the legal fiction of separate corporate entity. There was certainly no more than a formal change except insofar as the separate entity of the corporation was respected. It seems doubtful if the courts will allow a tax to be imposed upon an individual in such a case. While the precise point has never been decided, frequent decisions in the United States courts, including the Supreme Court, disregard paper transactions for income tax purposes, and even disregard the doctrine of corporate entity for many purposes.[125]

In several cases in which property was turned over to a corporation formed for the purpose, the Treasury Department held the owner of the property taxable to the extent of the difference between the market value (as defined by the department) of the stock received and the value of the property on March 1, 1913, or its cost, if acquired subsequently to that date even though the beneficial interest in the property was not substantially changed by the transaction.[126] The facts in these

[125] So. Pac. Co. v. Lowe, 247 U. S. 330; Gulf Oil Corp. v. Lewellyn, 248 U. S. 71. In the dictum in U. S. v. Alpha Portland Cement Co., 257 Fed. 432, 242 Fed. 978, 261 Fed. 339, Judge Dickinson, speaking on the income tax alleged to be due by reason of the receipt of certain stock upon the reorganization, said "If the law is construed with these grounds, indicating this policy in mind, we must construe the words 'income received' as meaning actually received, and not to include something which exists merely as a figment of the imagination." The modern tendency of the courts is to disregard paper or bookkeeping transactions for purposes of determining income tax liability. (See Doyle v. Mitchell, 247 U. S. 279; Forty Fort Coal Co. v. Kirkendall, 233 Fed. 704; U. S. v. Guggenheim Exploration Co., 238 Fed. 231), to look beyond the corporate form to the purpose of it, and to ignore the corporate entity in favor of the substance of things (See McCaskill v. U. S., 216 U. S. 504; U. S. v. Lehigh Valley Co., 220 U. S. 254; U. S. v. Milwaukee Co., 142 Fed. 247, 253; In re Watertown Paper Co., 169 Fed. 252.) But see U. S. v. Phellis, 42 Sup. Ct. Rep. 63; Eisner v. Macomber, 254 U. S. 189. The doctrine of corporate entity is discussed more fully in Chapter 10.

[126] The department bases its attitude in this respect in large part upon the refusal of Congress in drafting the Revenue Act of 1918 to permit to go into the law as enacted a provision proposed in a senate amendment to the effect that when a person or persons owning property received in exchange for such property stock in a corporation formed to take over such property, no gain or loss was to be deemed to accrue from the exchange. (See A. R. R. 173, T. B. 28-20-1050; A. R. M. 67, T. B. 28-20-1049.)

cases and the decisions of the department are briefly reviewed below:[127]

1. Several individuals secured leases on certain land. Subsequently and prior to March 1, 1913, they entered into a contract with another individual whereby 3,000 acres of the land were assigned to the latter individual under the so-called checkerboard plan and under which the assignee obligated himself to develop the field. If oil or gas was not found in the field by a well drilled to the depth of 1,200 feet, the assignee had the option of abandoning the contract. The assignee went upon the property and drilled a well after March 1, 1913, which struck oil. Subsequently in August, 1913, the leases in question were transferred to a corporation in exchange for the stock thereof, the major portion of which was sold by the stockholders in 1916. Under these circumstances the department held the stockholders of the corporation taxable in the year 1913 on the difference between the value of the stock received by them in August, 1913, and the value of their stock as of March 1, 1913. In determining such value as of March 1, 1913, it was recommended that the original cost of the leases transferred to the corporation plus the approximate cost of the wells sufficient to determine whether or not oil was present should be accepted: that upon the sale of the stock in 1916 the profit should be computed on the basis of the value of the stock in August, 1913.[128]

2. A taxpayer individually built and owned a railroad constructed for the sole purpose of carrying the product of his mills to stations on other roads for distribution. In 1914 the state railroad commission required the incorporation of this road. The commission permitted the issuance of stock by the corporation in an amount somewhat exceeding the net assets of the road upon the basis of an appraisal on March 1, 1913, and the cost of additions between that date and the date of incorporation, making due allowance for bond issue. The taxpayer contended that the property was worth at the time of incorporation the amount for which it was incorporated and that (a) a profit was made in 1914 at the time of incorporation, and (b) a loss was suffered upon the sale of the stock in 1917. The department held that while in the ordinary case of an exchange of property for stock, the latter would be deemed to be worth its par value in the absence of evidence to the contrary, the above appraisal indicated a value of less than par.

[127] See in addition to cases below, A. R. M. 94, T. B. 47-20-1310.
[128] A. R. R. 173, T. B. 28-20-1050.

Consequently the loss claimed upon the sale in 1917 was converted into a profit by the use of the appraised value of the railroad property in lieu of the par value of the capital stock issued by the company. The department agreed with the taxpayer's general contention indicated under (a) above, but the use of such appraised value precluded any profit upon the organization of the corporation in 1914.[129]

3. In a case in which an inventor formed a company and issued stock based upon his invention, the market value of which when issued was unknown, but for which stock the inventor subsequently proceeded to establish a market, receiving as compensation shares of the company's stock which he sold afterwards in the open market at more than par value, the department held that the amount received for the stock when sold in excess of its par value might reasonably be attributed to the inventor's efforts at publicity and the market value of the stock when received considered equal to its par value.[130]

Evasion of Tax on Sale of Corporate Assets by Conveyance to Trustees. A change of form from that of a corporation or association to that of a trust or partnership accompanied by a transfer of capital assets to trustees for the benefit of shareholders followed by a sale of such assets at a price in excess of the cost thereof to the corporation or association, and the distribution of proceeds to the beneficiaries (shareholders), such change being made for the main purpose of avoiding the tax which would, under the 1918 Law, have accrued to the corporation if the sale had been made by it, has been disregarded by the Treasury Department as a mere sham to avoid assessment of tax against the corporation or association upon the profit derived from such sale, and the corporation or association has been required to return as income any profit derived as though the sale had been made by it directly.[131]

[129] A. R. R. 126, T. B. 22-20-967.

[130] O. 962, T. B. 1-20-656.

[131] S. 1385, T. B. 19-20-928. See, however, L. O. 1062, T. B. 14-21-1548. For cases on the general principle that where the effect of a transaction is to evade the payment of a tax, the courts will look beyond the surface facts and sham devices and inquire into the real nature of the transaction. See Sisler v. Foster, 72 Ohio 437, 74 N. E. 649; People v. Albany Ins. Co., 92 N. Y. 458; People v. Sawyer, 27 N. Y. Supp. 202; Pollard v. First Natl. Bank, 47 Kans. 406, 28 Pac. 202; Ransom v. Burlington, 111 Iowa 77, 82 N. W. 427; Stefel v. Brown, 24 Mo. App. 102; Holly Springs, etc. v. Supervisors, 52 Miss. 281; Jones v. Seward Co., 10 Nebr. 154, 4 N. W. 946; Mitchell v. Commissioners, 9 Kans. 344, 91 U. S. 206; Albany City National Bank v. Maher, 6 Fed. 417, 19 Blatch. 175; Shotwell v. Moore, 45 Ohio 632, 16 N. E. 470, 129 U. S. 590; Durham v. State, 6 Ind. App. 23, 32 N. E.

Property Acquired by Bequest, Devise or Inheritance. The Revenue Act of 1921 prescribes an explicit basis for determining gain or loss upon the disposition of property acquired by bequest, devise or inheritance. The basis prescribed is "the fair market price or value of such property at the time of such acquisition."[132] This is a statutory enactment of the basis provided by regulations under the 1918 Law. The taxable gain derived or loss sustained upon the sale or other disposition of such property will be the difference between the price received and such fair market value, making proper allowance for depreciation or depletion deducted with respect to the property. If the property was so acquired by bequest, devise, or inheritance prior to March 1, 1913, the fair market price or value on that date will be used in calculating the gain or loss in the manner indicated above.[133] For the purpose of determining the profit or loss from the sale of property acquired by bequest, devise or inheritance since February 28, 1913, its value as appraised for the purpose of the federal estate tax, or in the case of estates not subject to that tax, its value as appraised in the state court for the purpose of state inheritance taxes, should be deemed to be its fair market value when acquired.[134] This provision applies to the acquisition of property or property interests which a decedent has created in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of the 1921 Law). Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without a fair consideration, will be deemed to have been made in contemplation of death unless the contrary is shown. The provision also applies to the acquisition of property or property interests passing under a general power of appointment exercised by a decedent (1) by will, or (2) by deed

104; Peppleton v. Yamhill, 8 Ore. 337. See also Southern Pacific Co. v. Lowe, 247 U. S. 330; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71. The distinction between a legal avoidance and an improper evasion must be kept in mind. (Bullen v. Wisconsin, 240 U. S. 625; U. S. v. Isham, 17 Wall. 476.)

132 Revenue Act of 1921, § 202 (a) 3.

133 See p. 413.

134 Reg. 45, Art. 1562, as amended by T. D. 3206, T. B. 33-21-1767; O. D. 667, T. B. 39-20-1209. This is only a presumption which may be rebutted by competent evidence (A. R. M. 7, T. B. 30-19-637).

executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death.[135]

Where real estate was devised by a testator to his widow for her life with the direction that upon her death the property should be sold and the proceeds divided among their children, the basis for ascertaining the gain or loss on a sale of such real estate and the distribution of the proceeds to the children has been held to be the value of the children's rights at the time such rights vested or on March 1, 1913, if they vested prior thereto. Under the doctrine of equitable conversion the interest of the children was regarded as personalty instead of realty, yet the estate acquired by the children was a remainder and vested at the death of the testator.[136] In spite of the provision that the land should be sold the children could have taken the actual land itself after the death of the life tenant instead of the proceeds from its sale.[137] The only difference between the subject matter disposed or by sale in behalf of the children after the death of the life tenant and that acquired by them on the death of the testator was that the former carried with it the actual possession of the property and the latter did not. Notwithstanding that fact, the right to the possession vested in the children at the death of the testator; the enjoyment alone was postponed to the death of the life tenant. Likewise, all the rights which the children acquired with respect to the land vested at the death of the testator and were as perfect then as at the death of the life tenant.[138] The remainder acquired by the children on the death of the testator was essentially the same property as the fee simple sold in their behalf after the death of the life tenant. It has also been held by the Treasury Department that the exemption in the statute given to property acquired by gift, bequest, devise or descent, refers merely to the value of the property at the time acquired and not to any value subsequently attaching to the property because of the actual or anticipated arrival of the period of enjoyment. Thus, in the above case, while the possession of the property devised did not vest in the children until the death of the widow, the property was acquired by the children *in right* on the death of the testator, and the measure of gain or loss on the sale of

[135] See Revenue Act of 1921, § 402 (c), (e).

[136] Cropley v. Cooper, 19 Wall. (U. S.) 167, 22 L. ed. 109; Kelly v. Gonce, 49 Ill. App. 82; DeVaughn v. McLeroy, 82 Ga. 687, 10 S. E. 211.

[137] Jarman on Wills, p. 562.

[138] Scofield et al. v. Olcott et al., 120 Ill. 362, 11 N. E. 351, 352; Nichols v. Levy, 5 Wall, (U. S.) 433, 442-3.

the property was held to be the difference between the selling price and the fair market price or value of the remainder interest of the children on March 1, 1913, the testator having died prior to that date. Had the testator died subsequently to March 1, 1913, the measure would have been the difference between the selling price and the fair market price or value on the date of the testator's death.[139] The basis for the determination of gain or loss upon the sale of a vested remainder interest has been held to be the value of the interest at the date of the death of the testator, or March 1, 1913, if the testator died prior to that date. This has been held to be true even in the case of an interest subject to being divested in the event of the death of the remaindermen without issue prior to the death of the life tenant, or by the disposition of the property devised during the life tenant's lifetime.[140] Where in the bequest of property the remaindermen have only a contingent interest prior to the death of the life tenant, the basis of determining gain or loss from a sale of the property by the remaindermen is its value as of the date of death of the life tenant.[141]

Property Acquired by Gift. An essential change is made by the Revenue Act of 1921 in prescribing the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property acquired by gift after December 31, 1920. It is provided[142] that in the case of such property "the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner." In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof is the fair market price or value of such property at the time of such acquisition. This provision does not apply to gifts made in contemplation of death, nor to gifts made

139 Sol. Op. 35, T. B. 33-20-1126.

140 O. D. 694, T. B. 43-20-1255.

141 O. D. 727, T. B. 46-20-1301.

142 Revenue Act of 1921, § 202 (a) 2.

to take effect in possession or enjoyment at or after death. Such testamentary gifts are treated as bequests or devises.[143]

The purpose of this provision may be gathered from the following statement:[144] "No explicit rule is found in the present statute for determining gain or loss resulting from the sale of such property, but the treasury department has held that the proper basis for such determination is the fair market price or value of such property at the time of its acquisition by the donee. This rule has been the source of serious abuse. Taxpayers who have property the value of which has increased, give such property to wives or relatives, by whom it may be sold without taxation of the increase in value which took place while the property was owned by the donor."

GIFTS UNDER 1918 LAW. As indicated in the quotation in the preceding paragraph, under the 1918 Law, the basis for ascertaining gain or loss in the case of property acquired by gift was the fair market price or value of the property at the time of acquisition by gift.[145] The following opinion was issued under the 1918 Law in definition of gifts:

(a) Where it appears that the owner of property has purported to transfer it without consideration to a member of his own family, or to any other person with whom he is in confidential relations, and that shortly thereafter a profitable sale of the security or property so transferred has occurred, such facts constitute *prima facie* evidence that the purported gift was not an actual gift and that the transfer was, in fact, merely colorable. In such case the so-called gift should be ignored in calculating tax, and the case should be investigated for evidence on which a charge of fraud could be supported in a contest.

(b) The *prima facie* case made out by the facts mentioned in the preceding paragraph may be rebutted by proof which establishes that it was not a transaction primarily for the advantage of the donor, and that there was no agreement or understanding, tacit or otherwise, that the donor was to receive back the proceeds or at any time control their disposition. Mere statements by the parties to the effect that the gift was genuine are regarded as of little weight; the best proof that a gift was a real gift would consist of facts showing that the position or

[143] See Report of Finance Committee on Internal Revenue Bill of 1921, p. 11. See p. 456.

[144] See Report of Finance Committee on Internal Revenue Bill of 1921, p. 10; Report of Ways and Means Committee, p. 9.

[145] Reg. 45, Art. 1562, as amended by T. D. 3206, T. B. 33-21-1767. See O. D. 1112, T. B. 48-21-1940.

relationship of the parties is such as to show a reasonable occasion for such a gift being made, and such as to explain the sale by the donee. Inquiry should be made as to the disposition of the proceeds.

(c) Where a taxpayer purports to make a gift to a member of his family or to a person in a confidential relation to himself, but no sale occurs, the question whether such gift was real or merely colorable is one to be decided on all of the facts. The mere fact that such conveyance is made may not lawfully be regarded as proof of fraud; but if the effect of the gift is to diminish tax liability, and it appears, either at the time of the gift or at any time thereafter, that the donor is deriving advantage from the property which he purported to give away, such facts constitute prima facie evidence that the gift was only colorable and the transaction should be treated as a nullity unless other facts are developed which show that it was a true gift. If such a gift is colorable only and made for the purpose of escaping tax, the donor is guilty of fraud and subject to penalty and punishment therefor.[146]

An individual in 1893 purchased a tract of land and deeded it to his wife. Shortly thereafter a part of the land was sold, the purchaser subsequently defaulting under a purchase money mortgage and the husband some time before March 1, 1913, bought in the property at a foreclosure sale placing the title again in his wife's name, the wife from 1913 to 1917, inclusive, including the income from the property in her income-tax returns. In 1917 the property was transferred to the husband, but the deed was never recorded. For 1918 the income from the property was reported by the husband. In 1919 the property was again sold, the wife giving the deed. The treasury department held that the wife was at all times, during the period in question, the real owner of the property, and any gain or loss upon the sale thereof in 1919 should be included in her return for that year, since the land was deeded to the wife as a *bona fide* gift in 1893, and since the husband who loaned the money to the purchaser and of right held the mortgage upon the property allowed the deed to remain in his wife's name when he bought the property in at the foreclosure sale, and since all the income for the years 1913 to 1917, inclusive, was reported in the wife's returns, indicating the husband's acknowledgment of her right to it. There were other circumstances indicating that the unrecorded deed of 1917 was not considered by the parties as a valid and binding transfer. The

[146] S. 1022, T. B. 7-19-290.

deed of transfer in 1919 when the property was sold was executed in the wife's name and the mortgage to secure a portion of the purchase price was taken in her name and later assigned to the huband, the wife continuing to be the record owner until the deed of sale.[147]

Sale of Homestead. The basis for determining gain or loss from the sale of a homestead acquired from the government will be the fair market value of the homestead at the date of its acquisition. The date of acquisition of a homestead acquired by public grant is the date of entry upon the land. The taxpayer will not be entitled to add to the value of the homestead the amount expended for relinquishment in order to clear the land office records, nor any fees paid to the government, but the cost of improvements may be added to the value as of the date of acquisition.[148] The above rule is limited to the original entryman, and has no application to the case of those acquiring government lands in any other way than under the homestead laws.[149]

Sales and Dealings in Bonds. It has been held under the 1918 Law that the property received on exchange of a so-called convertible bond for stock pursuant to such a privilege granted in the bond may produce income if the stock received in exchange has a fair market value in excess of the cost of the bond.[150] The exchange of old bonds of a corporation for bonds of a new issue having an extended maturity date and bearing a higher rate of interest has also been held to be an exchange of property which may result in gain or loss.[151] No taxable income accrued under the 1918 Law on an exchange of bonds purchased prior to March 1, 1913, for 57% of the face value of the old bonds in new bonds of the same company and 43% in cash. The cash was regarded as a return of part of the March 1, 1913, value of the old bonds, and the cost of the new bonds for the purpose of computing gain or loss in case of sale or other disposition of such bonds was deemed to be the difference between the cash received at the time of exchange and the value of the old bonds on March 1, 1913.[152] Where a corporation reduced its capital

[147] O. D. 543, T. B. 24-20-999.

[148] O. D. 386, T. B. 5-20-712; O. 880, T. B. 17-19-470. If the date of acquisition was prior to March 1, 1913, see p. 413 for the method of computing taxable gain or deductible loss in case of sale.

[149] O. D. 601, T. B. 30-20-1086.

[150] Reg. 45, Art. 1563.

[151] O. D. 308, T. B. 25-19-580.

[152] O. D. 98, T. B. 2-19-143.

stock by one-half and a stockholder therein surrendered his certificate for 10 shares acquired prior to March 1, 1913, and received in exchange a new certificate for 5 shares and an amount of cash, it was held under the 1918 Law that the amount by which the cash exceeded the value as of March 1, 1913, of the 5 shares surrendered represented taxable income to the stockholder for the year in which the exchange took place. The 5 new shares were held to have taken the place of the 5 old shares for which no payment in cash was received.[153]

Municipal Bonds Purchased at a Premium or Discount. When municipal bonds are purchased at a premium and held to maturity, their purchase price, including the premium, determines whether there is a gain or loss on the bonds, the gain or loss to be measured according to whether the bonds were purchased before or after March 1, 1913.[154] Profit derived from state and municipal securities purchased at a discount is not taxable in the hands of the person holding such obligations at maturity except that in no case may such exemption exceed the total discount at which the securities were originally sold by the state or municipality. Inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount), any person selling municipal bonds for an amount in excess of the cost of the bonds to him may realize a taxable profit, even though the bonds were issued at a discount.[155]

Surrender, Exchange and Sale of Insurance Policies. An insurance policy is property.[156] In determining the question of the taxable gain arising upon exchanges of insurance policies, such exchanges are to be divided into classes as follows:

(1) Cases in which the second policy at the time of issuance has no readily determinable cash value, and

(2) Cases in which the second policy at the time of issuance has a readily determinable cash value, and

(a) The value of the surrendered policy as of March 1, 1913, is greater than the gross premiums charged prior to that date, less amounts returned, deducted or abated therefrom, or

(b) The value of the surrendered policy as of March 1, 1913, is not greater than the gross premiums charged prior to that date, less amounts returned, deducted, or abated therefrom.

153 O. D. 693, T. B. 43-20-1254.

154 See O. D. 726, T. B. 46-20-1300.

155 See O. D. 737, T. B. 48-20-1321.

156 Ionia Co. Savings Bank v. McLean, 84 Mich. 629, 48 N. W. 159.

In cases falling in Class 1 no taxable gain arises from the exchange.

In cases falling in Class 2(a) the taxable gain, if any, arising from the exchange is the amount whereby (1) the sum of the value of the policy surrendered as of March 1, 1913, plus the gross premiums subsequently charged, less amounts returned, deducted, or abated therefrom, is exceeded by (2) the cash, if any, received upon surrender of the first policy, plus the cash value of the second policy.

In cases falling in Class 2(b) the taxable gain, if any, arising from the exchange is the amount whereby (1) the gross premiums charged at any time, either before or on or after March 1, 1913, less sums returned, deducted, or abated therefrom, are exceeded by (2) the cash, if any, received upon surrender of the first policy plus the cash value of the second policy.[157]

The surrender value of an insurance policy as of March 1, 1913, may be used as a basis for the purpose of ascertaining the gain derived from the sale or other disposition thereof.[158] The distinction has been made between the surrender of a policy and the sale thereof to some one other than the company which wrote the policy, and the ruling made that upon such a *sale* the cash surrender value on March 1, 1913, is the basis.[159] But it would seem that upon any disposition of an insurance policy, whether to the insurer or a third party, the insured is entitled to use the aggregate premiums paid as a basis for ascertaining any taxable gain, if the amount thereof is greater than surrender value on March 1, 1913, plus net premiums subsequently charged. In other words, the ruling at the beginning of this paragraph would seem to express the correct basis for determining gain upon a sale as well as a surrender or exchange.[160] Where a corporation which carried insurance policies on the lives of its officers under which it was named as the beneficiary sells the policies for a sum less than the total premiums paid

[157] Sol. Op. 55, T. B. 36-20-1181; Reg. 45, Art. 87, as amended by T. D. 3206, T. B. 33-21-1767; O. D. 379, T. B. 4-20-701. This ruling was made under the 1918 Law. Under the present law, if an insurance policy is held "for investment" and is exchanged for property of a "like kind or use", (another policy) there would seem to be no taxable profit. On the point that insurance policies are held for investment to some extent see Penn Mutual Life Insurance Co. v. Lederer, 252 U. S. 523.

[158] Reg. 45, Art. 87, as amended by T. D. 3206, T. B. 33-21-1767.

[159] O. D. 379, T. B. 4-20-701.

(and not deducted from gross income), no part of the amount received for the policies is taxable.[161]

Sale of Mines, Oil and Gas Wells. In computing the gain or loss from the sale of mines, oil and gas wells discovered on or after March 1, 1913, a taxpayer is not entitled to set up the value as of the date of discovery, or within 30 days thereafter, as the basis of the computation. The provision fixing the basis for determining gain or loss from the sale of property or its cost, as the case may be, contains no exception except that fair market value on March 1, 1913, may be used in certain instances. The provision relating to value at the date of discovery, or within 30 days thereafter, relates to the *depletion allowance* and not to a sale of mines, oil and gas wells.[162]

Sales of Property Involving Installment and Deferred Payments. While the Revenue Act of 1918 contained no provision respecting the taxation of profits from sales of property involving installment and deferred payments, the treasury department permitted taxpayers to report as income that proportion of each installment payment which the gross profit when the property is paid for bears to the gross contract price.[163] The Revenue Act of 1921 refers to such transactions in its provisions respecting exchanges of property and provides that nothing in such provisions shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.[164] The remaining paragraphs of this chapter deal with the taxation of profits from such transactions and from the sale of real estate in lots.

It is to be noted that the above provision of the Revenue Act of 1921 refers only to the method of computing the tax and

[160] See O. D. 1037, T. B. 38-21-1827.

[161] O. D. 724, T. B. 45-20-1297.

[162] Sol. Op. 26, T. B. 29-20-1068. This ruling, though made under the Revenue Act of 1918, is equally applicable under the present law. The fact that this construction of the statute involves a discrimination in favor of a discoverer who *operates* and against a discoverer who *sells*, does not affect this conclusion, since the statute is free from ambiguity. Moreover, a construction of the statute permitting a taxpayer to set up a value as of the date of discovery, or within 30 days thereafter, for the purpose of determining gain or loss upon a sale would negative the provisions of the statute limiting the surtax and the war-profits and excess-profits tax upon a sale of mines, oil and gas wells.

[163] Reg. 45, Art. 42, as amended by T. D. 3082.

[164] Revenue Act of 1921, § 202 (f).

allocating income upon sales involving installment payments. It would seem that the rules established by the Revenue Act of 1921 for the determination of the existence of a gain or loss, that is, whether a gain or loss may be said to occur, will apply to transactions involving installment and deferred payments. There is certainly no reason why such transactions should be classed differently for this purpose from transactions which do not involve installment payments. It is also to be noted that the capital gain provision may apply to transactions involving installment and deferred payments and that the provision that no gain or loss shall be recognized when property held for investment or for productive use in trade or business is exchanged for property of a like kind or use may apply to some of the transactions discussed in the following paragraphs.

Sale of Personal Property on Installment Plan. Dealers in personal property ordinarily sell either for cash, or on the personal credit of the buyer, or on the installment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25%) that the sale, though involving deferred payments, is not one on the installment plan. In sales on personal credit, and of the substantial payment type just mentioned, obligations of purchasers are to be regarded as the equivalent of cash,[165] but a different rule applies to sales on the installment plan. Dealers in personal property who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default: (a) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (b) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (c) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (d) by convey-

[165] The treasury department recognizes that in many sales of that type the obligations of purchasers, even though represented by notes or other paper in negotiable form, can not be discounted or otherwise converted into cash without material loss because of lack of credit on the part of the buyer and the nature of the property covered by such contract. In such cases the profits from such sales may be computed in accordance with the rules prescribed for sales or contracts for sale of personal property on the installment plan, provided the taxpayer chooses to do so as a matter of consistent practice and attaches to his return a statement disclosing that fact and showing conclusively that the obligations of the purchasers are not the equivalent of cash. (O. D. 715, T. B. 45-20-1287.)

ance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly applicable rule be established. The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from installment sales (such collections being allocated to the year against the sales of which they apply) which the annual gross profit to be realized on the total installment sales made during each year bears to the gross contract price of all such sales made during that respective year. In any case where the gross profit to be realized on a sale or contract for sale of personal property has been reported as income for the year in which the transaction occurred, and a change is made to the installment plan of computing net income, no part of any installment payment received subsequently to the change, representing income previously reported on account of such transaction, should be reported as income for the year in which the installment payment is received; the intent and purpose of this provision is that where the entire profit from installment sales has been included in gross income for the year in which the sale was made, no part of the installment payments received subsequently on account of such previous sales shall again be subject to tax for the year or years in which received. Where the taxpayer makes a change to this method of computing net income his balance sheet should be adjusted conformably. If for any reason the vendee defaults in any of his installment payments and the vendor repossesses the property, the entire amount received on installment payments, less the profit already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible.[166]

[166] Reg. 45, Art. 42, as amended by T. D. 3082. In England it has been held that the phrase, "annuities or other annual profits or gains," as used in 5 & 6 Vict., Chapter 35, § 102, which imposes an income tax on same, does

SCOPE OF METHOD. The treatment outlined above for sales of personal property on the installment plan is not limited to dealers alone, or to sellers of chattels as distinguished from sellers of other forms of personal property, such as corporate stock. The retention of a lien upon the property sold as security for the purchaser's agreement to pay, does not alter this conclusion.[167] If the principal stockholder of a corporation sells stock to employees of a company for consideration of 10 per cent. cash and the balance in installment payments secured by notes covering a period of 10 years, that proportion of each installment payment received during the taxable year which the gross profit to be realized bears to the gross contract price should be reported as income for the year during which installment payments were received.[168]

COMPUTATION OF INCOME FROM INSTALLMENT SALES OF PERSONAL PROPERTY. Income from installment sales to be returned in each taxable year will consist of: (1) Such part of the installments received during the year (excluding those installments received on account of property repossessed during the year) as represents realized profit. Installments received during the year are to be included whether the sales were effected in an earlier or in the current taxable year. The profit on such installments should be computed by taking the same percentage of the installment receipts as the gross profit to be realized on the total installment sales made during the taxable year bears to the

not apply to installments of the purchase price of an estate, although such payments are due yearly and extend over a long period of years, the installments being regarded as parts of a debt or capital, and not profits and gains to which the act applies, and this even though a part of the installments consists of profits. (Foley v. Fletcher (1858), 3 Hurst. & N. 769, 157 Eng. Reprint, 678, 28 L. J. Exch. N. S. 100, 5 Jur. N. S. 342, 7 Week. Rep. 141, 4 Mor. Min. Rep. 130.) In regard to sales, both of real and personal property, where title passes immediately to the vendee, the treasury department's early rulings required the return of the profits from the sale as income for the year in which the sale was made. If the buyer forfeited his contract and failed to meet any of the payments contracted to be made, the vendor was permitted to deduct from his gross income as a loss such proportion of the defaulted payments as was previously returned as income. The early rulings, where title did not pass absolutely to the vendee, are contained in a letter from the treasury department dated March 14, 1917; Income Tax Primer, December 17, 1917, Question 32. On April 25, 1918, in T. D. 2707 the treasury department modified Reg. 33 Rev., Arts. 117 and 120 and established the ruling that until personal property sold on the installment plan is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price

[167] S. 1353, T. B. 13-20-806; O. D. 482, T. B. 18-20-894.

[168] O. D. 134, T. B. 4-19-212.

gross contract price of all such sales. Any necessary corrections to produce a more accurate result can be made as at the end of the taxable year. (2) The profits, if any, on contracts which during the year have been canceled, the goods being repossessed by the vendor. In such cases the entire profit realized on the canceled contract, less so much thereof as has been returned in previous years, should be returned as profit of the taxable year in which the goods are repossessed. In estimating such profit the value of the repossessed article (taken at its cost to vendor, less proper allowance for damage and use) should be taken into account, as well as all installments received on account of the contract. Where an installment house makes sales which are not on the installment plan, the profit on such completed sales will be determined in the regular manner.[169]

The following is an illustration of the computation of income from sales of personal property on the installment plan: In 1917 goods which cost $10,000 are sold on installment plan for $20,000. Collections on account: 1917, $10,000; 1918, $9,800. One contract, originally for $500, is defaulted in 1918 and the goods which cost the vendor $250 are repossessed, being then worth $50. Installments on this defaulted contract had been paid as follows: 1917, $100; in 1918, $200. The profits to be returned in 1918 are:

Under (1) 50% of $9,600 ($9,800—$200)			$4,800
Under (2) total installments received		$300	
Less-Profit returned in 1917	$ 50		
Shrinkage in goods repossessed ($250—$50)	200		
		250	
			50
Total profit returnable in 1918			$4,850

For simplicity, the above illustration omits sales in 1918. If sales in 1918 contain a different percentage of profit than those in 1917, some adjustment may be necessary. Where the adoption of the method outlined above involves a change in the method of computing net income, the taxpayer's balance sheet should be adjusted conformably as of the date when the change is effected. If the vendor chooses as a matter of consistent practice to treat

[169] Letter from treasury department dated April 26, 1919; I. T. S. 1921, ¶ 969.

the obligations of purchasers as the equivalent of cash, such a course is permissible.[170]

METHOD OF ACCOUNTING TO BE EMPLOYED. The following has been adopted where a taxpayer engaged in merchandising upon the installment plan has heretofore made returns upon the basis of treating the profit upon installment sales as realized as at the date of sale and now wishes to change to the basis of reporting the profit as being realized as at the date of collection of the outstanding accounts. In accordance with the rule above stated the balance sheet as at the beginning of the taxable year, which should be filed as a part of the return, will carry the installment sales contracts unliquidated and remaining in force as at the date that this system of accounting is adopted and made effective by the taxpayer, as accounts receivable, such unliquidated installment sales contracts having been inventoried and determined as at that date. Cash collections on account of such contracts will be credited directly to such accounts receivable and no part of such collections will be included in computing realized profits for the taxable year. As from the beginning of the taxable year, the following accounts should be set up:

(a) *Goods purchased*, which will be charged with the amount of inventory of the goods on hand at the beginning of the taxable year and with the expenditures for goods purchased during the year.

(b) *Goods sold* (cost values), which will be credited with the cost value of all goods sold during the year.

(c) *Installment sales contracts* (year date), which will be charged only with the amount of installment sales contracts made during the year specified. This account for each year will be credited with all cash collected during that year, or in subsequent years, upon installment sales contracts for that year only, and with the unpaid installments of defaulted or canceled contracts for that year.

(d) *Unrealized gross profits on installment sales contracts* (year date), which will be credited only with the amount of unrealized gross profits upon installment sales contracts made during the year specified. This amount will be the total of the installment sales contracts for that year reduced by the cost or inventory value, (as carried in account (a) goods purchased), of the actual goods sold and covered by the contracts; the balance

[170] Letter from treasury department dated July 10, 1919; I. T. S. 1919, ¶ 3486, T. D. 3082.

remaining being the amount of the unrealized gross profits. The proforma monthly (or annual) journal entry would be:

	Dr.	Cr.
Installment sales contracts (year date,)	$....	
To goods sold (cost value)		$....
Unrealized gross profits on installment sales contracts (year date)		$....

(e) *Realized profits on installment sales contracts,* which will be credited from month to month (or at the end of the year), with the profits realized by cash collections upon all installment sales contracts of any year. Such profits should be computed by taking the same percentage of the cash collections made during the taxable year on account of installment sales contracts of either that or prior years, as the total unrealized profits on installment sales contracts for the year against which the collection applies, bear to the total installment sales made during that respective year. Corresponding debits should be made to *unrealized gross profits on installment sales contracts* for the year affected by such collections. If adjustments to any or all of these various accounts become necessary in order that it or they may accurately reflect the facts, such adjustments may be made either monthly or as at the end of the taxable year.[171]

C. O. D. and "will call" sales should be included in the inventory at the close of the year, if the merchandise has not been actually shipped to the customers, unless such merchandise has been included in sales of the taxable year, in which case it should be excluded from inventory.[172]

It will be noted that the foregoing plan which will be permitted upon an explicit statement of facts made to the Commissioner by a taxpayer engaged in merchandising upon the installment plan is not a change from an accrual basis to a cash received and paid basis. In the opinion of the Commissioner, the income of a merchandising concern can not be correctly reflected upon the latter basis, as the use of inventories is absolutely essential. The plan herein outlined is, therefore, merely such a modification or adaptation of the ordinary accrual method of accounting as in the opinion of the Commissioner will enable the accounts of the taxpayer clearly to reflect his net income. Where in the past another method has been used that

[171] O. D. 623, T. B. 32-20-1118, modifying T. B. R. 24, T. B. 8-19-36.
[172] O. D. 24, T. B. 1-19-36.

has failed to reflect the taxpayer's net income an amended return or returns for such year may be made.[173]

If books have been so kept that the cost of each article sold was not shown, gross profit may be determined by taking the average percentage of gross profit on gross sales. If several different lines of merchandise are handled on which the average percentages of profit differ, the gross profit on total sales of each different class of merchandise should be computed separately.[174]

In cases of continuous accounts covering sales of personal property, the income from which is reported on the installment plan, the cash payments received should be allocated in accordance with the generally recognized principle of law governing such cases, that is, that failing application by the vendee, the cash payments should be applied to the earliest items of the account.[175]

It has been ruled that a taxpayer who sells merchandise on the installment plan may not allocate the expenses incident to producing the income to the year in which the profits on the sale of the goods are realized, but should deduct such expenses in the year in which incurred and paid or accrued.[176]

TREATMENT OF BAD DEBTS. The amount to be deducted from gross income as a bad debt in cases of sales of personal property on the installment plan in which the unpaid installment obligations of the purchaser become worthless and are charged off and the property is not recovered by the vendor is such proportion of the defaulted payments as represents the capital investment, that is, the cost of the goods sold, and this amount must be deducted for the year in which the default occurred. This rule may be made clear if the accounting procedure suggested above is followed under the conditions given in the following example:

Let it be assumed that the taxpayer's installment sales (contracts) for the year 1919 were $300,000 and that the cost of the goods sold and covered by such contracts was $100,000; then the unrealized gross profits would be $200,000 and the rate of profit for that year would be established at $66\frac{2}{3}$ per cent.

Let it be assumed, further, that during the years 1919 and 1920 the cash collections on account of such contracts were $266,700; then the entries covering these transactions would be as follows:

Installment sales contracts, 1919	$300,000	
To goods sold (cost value)		$100,000

173 O. D. 623, T. B. 33-20-1118, modifying T. B. R. 24, T. B. 8-19-313.

174 O. D. 25, T. B. 1-19-37.

175 O. D. 815, T. B. 8-21-1460; O. D. 1045, T. B. 39-21-1838.

176 O. D. 844, T. B. 11-21-1508.

To unrealized gross profits on installment sales contracts, 1919			200,000
Rate of gross profit—$\frac{2}{3}$ or $66\frac{2}{3}$ per cent.			
Unrealized gross profits on installment sales contracts, 1919		177,800	
To realized profits on installment sales contracts			177,800
Cash collections during 1919 and 1920 for account of 1919	$266,700		
$\frac{2}{3}$ thereof	177,800		

At the close of 1920 the accounts, as affected by the above transactions, would stand as below:

Debits.		Credits.	
Cash	$266,700	Goods sold (cost value)	$100,000
Installment sales contracts, 1919	33,300	Unrealized gross profits, etc.	22,200
	300,000	Realized profits, etc.	177,800
			300,000

Of the above balance of $33,300 to the debit of installment sales contracts, two-thirds, or $22,200 (shown as a balance to the credit of unrealized gross profits), is to be accounted for and taxed as profits as, when, and if collected. The remaining one-third is the capital investment representing the cost of goods sold.

But let it be assumed that the whole or any part of the balance of the installment sales contracts, amounting to $33,300, was defaulted in 1919 or at any later time; then the question arises: How should the loss occasioned by such defaults be treated for purposes of determining the income and excess profits tax?

The answer is that the proper portion (two-thirds in this case) of the amount of the defaulted payments should be charged against the unrealized profits and the balance (in this case one-third), representing the cost of the goods sold, should be allowed to the taxpayer as a deduction for losses actually sustained during the taxable year.

This method of treatment should be followed whether the goods are or are not recovered. If the goods are not recovered, it correctly reflects the facts without further entries upon the books. If the goods are recovered, their fair market value at the

time of recovery should be credited as realized profits for that year, with a corresponding debit to the account of goods purchased. The difference (debit balance) between the two accounts of goods purchased and goods sold should reflect the value of the physical inventory at any given date.[177]

COMBINATION OF CASH, CHARGE AND INSTALLMENT SALES. A corporation doing business on both a cash and installment basis should report profits on the installment sales on the basis outlined above. The cash sales, each of which represents a completed and closed transaction, should be reported separately, that is, the entire profits derived from every cash sale must be reported as income in the return for the year in which the sale was made.[178]

In the case of a combination of cash, charge, and installment sales, the cost of the goods sold is obtained in the usual manner which is the sum of the opening inventory and purchases for the year less the closing inventory. The percentage of gross profit on sales for the year is the percentage which the gross profit from all sales is of the total sales for the year, regardless of whether cash, charge, or installment sales. The percentage of gross profit for a particular year applied to the total collections for that year gives the gross income from sales for such year. This percentage remains the same for collections on installment sales contracts for a particular year regardless of whether such collections are made in the year in which the sale was made or in a later year. Collections made in subsequent years on prior installment sales contracts must, of course, be allocated and credited to the year in which the sale was made. In addition to the special accounts enumerated above the other accounts which would normally be maintained are the same as those of an ordinary business adapted if necessary to furnish the information desired at the close of the accounting period.[179]

CHANGE IN METHOD OF REPORTING. In cases where the taxpayer has in the past exercised the option of reporting the profit as realized as at the date of sale and now wishes to change to a basis of reporting the profit as realized as at the date of collection of the outstanding installments, either of which method is allowable, amended returns for years prior to the date that the above outlined system of accounting is adopted and made effective by the taxpayer, will not be required or allowed unless in the opinion of the Commissioner such former method has failed to

[177] O. D. 792, T. B. 6-21-1427.

[178] O. D. 23, T. B. 1-19-35.

reflect the net income.[180] The Commissioner will not approve such a change merely because the taxpayer will derive an advantage from decreased tax liability. When a change is approved the taxpayer will be required to adhere to it in his returns for subsequent years and the first return made under the changed method should be accompanied by a letter of explanation.[181]

Sale of Real Estate Involving Deferred Payments. Deferred payment sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows: (1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount.[182] They include (a) sales where there is immediate transfer of title when a small initial payment is made, the seller being protected by a mortgage or other lien as to deferred payments, and (b) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the agreed installments have been paid. (2) Deferred payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments. In determining how these classes shall be treated in levying the income tax, the question in each case is whether the income to be reported for taxation shall be based only on amounts actually received in a taxing year, or on the entire consideration made up in part of agreements to pay in the future.[183] No realization of gain or loss arises from a mere contract to sell real estate in the future. The sale is held to occur at the time a deed passes or at the time possession and the burdens and benefits of ownership are from a practical standpoint transferred to the buyer, whichever occurs first. Payments made prior to the sale are to be applied in reduction of cost so far as they do not exceed cost; being treated as income to the extent, if any, to which cost is exceeded.[184]

[179] O. D. 1107, T. B. 47-21-1930.
[180] O. D. 623, T. B. 32-20-1118, modifying T. B. R. 24, T. B. 8-19-313.
[181] O. D. 24, T. B. 1-19-36.
[182] See A. R. M. 140, T. B. 46-21-1918.
[183] Reg. 45, Art. 44.
[184] O. 988, T. B. 8-20-751.

SALE OF REAL ESTATE ON INSTALLMENT PLAN. In the two kinds of transactions included in class (1) in the foregoing paragraph, installment obligations assumed by the buyer are not ordinarily to be regarded as the equivalent of cash, and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be income to the vendor, and will be so returned for the year in which the property was repossessed, and the property repossessed must be included in the inventory less any depreciation. If the taxpayer chooses, as a matter of settled practice consistently followed, to treat the obligations of the purchaser as equivalent to cash and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated the rule prescribed in the following paragraph will apply.[185]

DEFERRED PAYMENT SALES OF REAL ESTATE NOT ON THE INSTALLMENT PLAN. In class (2) in the next to the last paragraph above the obligations assumed by the buyer are much better secured because of the margin afforded by the substantial first payment, and experience shows that the greater number of such sales are eventually carried out according to their terms. These obligations for deferred payments are therefore to be regarded as equivalent to cash, and the profit indicated by the entire consideration is taxable income for the year in which the initial payment was made and the obligations assumed. If the buyer defaults and the seller regains title to the land by agreement or process of law, retaining payments previously made, he may deduct from his gross income as a loss in the year of repossession any excess of the amount previously reported as income over the amount actually received, and must include such real estate in his inventory at its original cost to himself less any depreciation.[186]

In the case of real estate sales involving deferred payments, even though substantial first payment is made, if the notes given by buyers of real estate can not be discounted nor sold on account of lack of credit of the buyers, such notes need not be regarded as the equivalent of cash, and the vendors may

[185] Reg. 45, Art. 45.
[186] Reg. 45, Art. 46.

report as their income from the proposed transaction for each year only the proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price.[187]

Where pursuant to a contract to sell real estate executed in one year at which time a small cash consideration was paid, delivery of the deed and transfer of possession taking place in the next year, in which latter year a substantial payment was made and notes secured by mortgage for the unpaid balance were given, it has been held that the vendor should report the profit realized from the transaction as gross income for the latter year and that the small advance payment made in the earlier year should be treated as a return of capital since it was less than the cost of the property to the vendor and did not, therefore, constitute taxable income for the earlier year.[188]

Where a tract of land was sold on November 1, 1919, 1/10 of the purchase price accompanying the bid, 4/10 being paid in December, 1919, and the balance in January, 1920, at which time a proper conveyance of title was delivered to the purchaser, the sale should be treated as a cash transaction for 1919 and the entire profit realized be returned as income for that year.[189]

Where an individual sold real estate receiving in the year of sale over ¼ of the total selling price, the contract providing that the balance should be paid in four annual installments thereafter, such deferred payments being secured by crop mortgages and additional collateral security, it has been held that the payments received in the year of sale were sufficiently substantial in amount to require the vendor to report in that year the entire profit realized on the sale.[190]

Where an individual sold real estate which was mortgaged to secure a loan made by a state, the vendor agreeing to make payment partly in cash, assumed payment of the morgtgage held by the state and gave the vendor a mortgage to cover the balance of the sale price, it has been held that the vendor has received the full amount of the sale price in cash or its equivalent and should report the entire profit realized as income for the year in which the sale was consummated, notwithstanding that

[187] O. D. 181, T. B. 8-19-314.

[188] A. R. R. 13, T. B. 2-20-671. See also O. D. 751, T. B. 51-20-1350; O. D. 842, T. B. 11-21-1506 and letter from treasury department dated April 27, 1921; I. T. S. 1921, ¶ 2991.

[189] O. D. 568, T. B. 27-20-1037.

[190] O. D. 569, T. B. 27-20-1038.

the state refused to accept the vendee's promise to pay in lieu of the vendor's original liability for payment of the note in case of default by the vendee.[191]

In 1920, a partnership owning a sawmill business entered into a contract for the sale of its property to a corporation. In accordance with the contract, the corporation made a cash payment of $200,000 down and obtained possession of the mill plant and equipment, a large tract of timber, together with certain leases and other rights, and all the timber owned by the partnership on certain other sections of land. The contract also required the corporation to make large cash payments in one, two, three and four years, respectively, from the date of the contract, and it was provided that as each of the stipulated payments was made, there should be released to the corporation all the timber owned by the partnership on certain other specified sections of land. Upon making the last payment stipulated in the contract a warranty deed to the property covered by the contract was to be executed and delivered to the corporation. A bond was given by the vendors for the execution and delivery of such warranty deed upon the fulfillment of the conditions by the vendee. The entire transaction was covered by the contract and the bond, the obligations of the vendee not being represented by notes or other negotiable paper in any form. It was held that the sale of the property covered by the contract should be considered as having taken place only when and as the stipulated payments were made and the property released to the corporation. The sale of each parcel of the property should, therefore, be treated as a separate transaction.[192]

Where, under the terms of a contract of sale of land near developed oil territory, one-half of the consideration was to be paid in cash and one-half in oil at the market price after the land is developed, the vendor having no recourse if oil is not found, it was held that the part of the consideration represented by the right to receive oil, in case oil is found, has not a definitely ascertainable value, and hence is not to be considered the equivalent of cash. No taxable income will be realized by reason of the sale until the amount received by the vendor in cash, plus the cash value of oil received, exceeds the cost of the property.[193]

Sale of Real Estate in Lots. Where a tract of land is purchased with a view to dividing it into lots or parcels of ground

191 O. D. 409, T. B. 11-20-784.

192 O. D. 835, T. B. 10-21-1493.

193 O. D. 889, T. B. 17-21-1591.

to be sold as such, the cost must be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels which constitutes taxable income may be returned as income for the year in which the sale was made. This rule contemplates that there will be a measure of gain or loss on every lot or parcel sold, and not that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction and the gain or loss will be accounted for in accordance with the rules for determining gain or loss from sales.[194] Profit realized on the sale of lots, the selling price of which includes the cost of certain development work already made or to be made in accordance with the contract of sale, should be based on the cost of the land to the vendor making the sale, plus the actual and estimated future expenditures for development. If the estimated future expenditures should be subsequently ascertained to be incorrect, amended returns should be filed as the basis for an adjustment of the tax for the years affected. The cost of such development having been taken into consideration in determining profit, expenditures for this purpose can not be deducted from gross income in subsequent returns.[195] The purchase of real estate with the intention of reselling it as a whole will not avoid the above method of treatment, if, in fact, the land is sold in several parts. The sale of a perpetual easement on a specified number of acres of land to a railroad company is to be treated as though it were an outright sale of land where legal title passes at the time of sale, unless for some reason the fee of the owner has more than a merely nominal value, as for example, where the land is underlaid by a mine.[196]

[194] Reg. 45, Art. 43, as amended by T. D. 3206, T. B. 33-21-1767. See Chapter 17.

[195] O. D. 567, T. B. 27-20-1036; O. D. 226, T. B. 12-19-399.

[196] O. D. 1072, T. B. 43-21-1881.

CHAPTER 18

INCOME FROM INTEREST, RENT AND ROYALTIES

Both the Revenue Act of 1921 and the Revenue Act of 1918 expressly provide that gross income shall include gains, profits, and income derived from "interest" and from "rent." The law does not expressly cover income from royalties, which falls, however, under the broad expression "income derived from sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also gains or profits and income derived from any source whatever." Interest is ordinarily taxable in the hands of citizens and residents and domestic corporations, whether received from debtors in this country or debtors in foreign countries. It is taxable in the hands of non-resident aliens and foreign corporations when it is paid on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise.[1]

Interest Exempt from Tax. The law expressly provides that interest upon the obligations of a state, territory or political subdivision thereof, or the District of Columbia or any possession of the United States, or securities issued under provisions of the Federal Farm Loan Act of July 17, 1916, or interest upon the obligations of the United States issued prior to September 1, 1917, (and to a limited extent the interest on obligations issued after that date) and bonds issued by the War Finance Corporation (to a limited extent) shall not be included in gross income, and shall be exempt from income tax.[2]

Interest upon United States Obligations. Although interest upon the obligations of the United States is in general exempt from tax, in the case of such obligations issued after September 1, 1917, which include treasury certificates of indebtedness, war savings certificates and the Liberty bond issues (except the First

[1] Revenue Act of 1921, §§ 213 (a) and 233; Revenue Act of 1918, §§ 213 (a) and 223. See Chapters 4 and 12 as to interest taxable in the hands of nonresident aliens and foreign corporations. As to interest, see Reg. 33, Art. 67; Letter from treasury department dated February 18, 1915; I. T. S. 1919, ¶ 923; Reg. 45, Art. 54. As to rent, see letters from Treasury Department dated February 9 and February 26, 1915. I. T. S. 1919, ¶ 920. Unless the taxpayer keeps his books on a basis other than that of actual receipts, he should report interest, rent and royalties as income of the year in which payment thereof is actually or constructively received by him.

[2] Revenue Act of 1921, § 213 (b) 4; Revenue Act of 1918, § 213 (b) 4.

Liberty Loan $3\frac{1}{2}$ per cent. bonds), the interest is exempt from tax only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented.[3] There are five issues of so-called Liberty Loan bonds comprising ten different classes of bonds and notes. These ten classes are as follows: (1) First Liberty Loan $3\frac{1}{2}\%$ Bonds; (2) First Liberty Loan Converted 4% Bonds; (3) First Liberty Loan Converted $4\frac{1}{4}\%$ Bonds (dated May 9, 1918); (4) First Liberty Loan $4\frac{1}{4}\%$ Bonds (dated October 24, 1918); (5) Second Liberty Loan 4% Bonds; (6) Second Liberty Loan Converted $4\frac{1}{4}\%$ Bonds; (7) Third Liberty Loan $4\frac{1}{4}\%$ Bonds; (8) Fourth Liberty Loan $4\frac{1}{4}\%$ Bonds; (9) Victory (Fifth) Liberty Loan $3\frac{3}{4}\%$ Notes; (10) Victory (Fifth) Liberty Loan $4\frac{3}{4}\%$ Notes. The respective acts[4] authorizing the issue of these obligations grant exemption in every case from any *normal*[5] tax upon the interest therefrom. Some of the obligations are wholly exempt from the surtax or the excess-profits tax (in the case of corporations), while others carry no exemption from such taxes. In addition, many of the obligations carry limited or partial exemptions as appear in the following paragraphs. The Revenue Act of 1921 has further amended and supplemented the various Acts authorizing the issue of Liberty bonds and has consolidated the Liberty bond tax exemptions.[6] As a result the exemptions under the 1921 law differ considerably from those previously granted.

Tax Exemptions of Liberty Bonds and Victory Notes Under the 1918 Law. I. Under the 1918 Law, the following bonds and notes were exempt from all federal, state, and local taxation, except (a) estate or inheritance taxes and (b) federal income surtaxes and profits taxes, as follows:

[3] Reg. 45, Art. 77. Under earlier income tax laws, interest upon the obligations of the United States was expressly included as taxable income (see Act of March 2, 1867). Under the 1909 Law the attorney-general held that interest on national bonds should be included as income of corporations, since the tax was not on property, but a tax on the privilege of carrying on business (28 Op. Atty. Gen. 138).

[4] Act of April 24, 1917; Act of September 24, 1917; Act of April 4, 1918; Act of July 9, 1918; Act of March 3, 1919; Revenue Act of 1921, § 1328.

[5] This word applies to the income tax on corporations as well as the normal tax on individuals. (Official announcement by treasury department, dated April 23, 1919; I. T. S. 1921, ¶ 1238.

[6] Revenue Act of 1921, § 1328.

1. First Liberty loan converted 4 per cent bonds of 1932-1947 (first 4s).
2. First Liberty loan converted 4¼ per cent bonds of 1932-1947 (first 4¼s, issue of May 9, 1918).
3. First Liberty loan second converted 4¼ per cent. bonds of 1932-1947 (first 4¼s, issue of October 24, 1918).
4. Second Liberty loan 4 per cent bonds of 1927-1942 (second 4s).
5. Second Liberty loan converted 4¼ per cent bonds of 1927-1942 (second 4¼s).
6. Third Liberty loan 4¼ per cent bonds of 1928 (third 4¼s).
7. Fourth Liberty loan 4¼ per cent bonds of 1933-1938 (fourth 4¼s).
8. Victory Liberty loan 4¾ per cent convertible gold notes of 1922-1923 (4¾ per cent Victory notes).

Were exempt, under the 1918 law, both as to principal and interest, from all taxation then or thereafter imposed by the United States, any state, or any of the possessions of the United States, or by any local taxing authority except (a) estate or inheritance taxes, and (b) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, then or thereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations.

II. 4 *per cent and 4¼ per cent bonds* were entitled to limited exemptions from federal income surtaxes and excess-profits taxes, as follows:

4 per cent and 4¼ per cent Liberty bonds (but not 4¾ per cent Victory notes) were entitled to certain limited exemptions from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, then or thereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations, in respect to the interest on principal amounts thereof, as follows:

$5,000 in the aggregate of first 4s, first 4¼s (issues of May 9 and October 24, 1918) second 4s and 4¼s, third 4¼s, fourth 4¼s, treasury certificates, and war-savings certificates.[7]

30,000 of first 4¼s (issue of October 24, 1918, only), until the expiration of two years after the termination of the war.

30,000 of fourth 4¼s, until the expiration of two years after the termination of the war.

30,000 in the aggregate of first 4s, first 4¼s (issues of May 9 and October 24, 1918), second 4s and 4¼s, third 4¼s, and fourth 4¼s, as to the interest received on and after January 1, 1919, until the expiration of five years after the termination of the war.

45,000 in the aggregate of first 4s, first 4¼s (issue of May 9, 1918, only), second 4s and 4¼s, and third 4¼s, as to the interest received after January 1, 1918, until the expiration of two years after the termination of the war; this exemption conditional on original subscription to, and continued holding at the date of the tax return of two-thirds as many bonds of the fourth Liberty loan.[8]

20,000 in the aggregate of first 4s, first 4¼s (issues of May 9 and October 24, 1918), second 4s and 4¼s, third 4¼s, and fourth 4¼s, as to the interest received on and after January 1, 1919; this exemption conditional upon original subscription to, and continued holding at the date of the tax return of one-third as many notes of the Victory Liberty loan, and extending through the life of such notes of the Victory Liberty loan.[9]

[7] Where a husband and wife each own in his own or her own right bonds of these issues not exceeding $5,000, each is entitled to exclude the income therefrom in computing the tax on their joint incomes, and minor children having separate estates are also entitled to the exemption. (Letter from treasury department dated October 8, 1917, I. T. S. 1921, ¶ 1244.) A taxpayer is entitled to the exemption of $5,000 of his aggregate holdings, not on $5,000 of each class of obligations (T. D. 2585).

[8] It has been held that an individual who originally subscribed to bonds of the Fourth Liberty Loan to an amount not exceeding $30,000 in accordance with the government plan and who made payments in accordance with such plan was not required to pay for such bonds in full on or before December 31, 1918, in order to obtain this exemption. Likewise, if an individual subscribed for bonds of the Fourth Liberty Loan through a bank by agreeing to pay the subscription price in installments acceptable to the bank, and make payments in accordance with this plan, it was not necessary for such individual to pay for the bonds in full on or before December 31, 1918, in order to obtain this exemption. Letter from treasury department dated January 3, 1919, I. T. S. 1919, ¶ 990.)

[9] For the purpose of this exemption Victory notes of either series issued upon conversion of Victory notes of the other series which were originally

III. $3\frac{1}{2}$ *per cent bonds and* $3\frac{3}{4}$ *per cent notes* were exempt from all federal, state, and local taxation, except estate or inheritance taxes, as follows:

1. First Liberty loan $3\frac{1}{2}$ per cent bonds of 1932-1947. 2. Victory Liberty loan $3\frac{3}{4}$ per cent convertible gold notes of 1922-1923.[10]	Were exempt, under the 1918 Law, both as to principal and interest, from all taxation (except estate or inheritance taxes) then or thereafter imposed by the United States, any state, or any of the possessions of the United States, or by any local taxing authority.

Bonds Originally Subscribed for and Held at the Date of the Tax Return. The amount of interest upon Liberty bonds of any particular loan exempt from surtax and war-profits and excess-profits tax was in no case based on the amount of bonds of that loan subscribed for and still held at the time of filing the return. However, the conditional exemption of interest upon Liberty bonds of other loans by reason of original subscription and continued holding of Liberty bonds of the fourth loan, or Victory notes, was based upon the amount of Liberty bonds of the fourth loan and Victory notes originally subscribed for and still held by the taxpayer at the time of filing his return.[11] The words "the date of the tax return" as used in the supplement to the Second Liberty Loan Act were held to mean the date on which the return is filed with the collector. Consequently a taxpayer holding the prescribed amount of fourth Liberty loan bonds on December 31, 1918, but who disposed of them on January 1, 1919, before his return had been filed, was not allowed the exemption referred to.[12] An individual who inherited fourth Liberty Loan bonds or Victory Loan notes which were originally subscribed for by the decedent was not entitled to the collateral exemption of interest on bonds of previous issues to which the decedent as the original subscriber

subscribed for by any taxpayer will be deemed to have been originally subscribed for by such taxpayer. (T. D. 2857.) The total possible exemptions from federal income surtaxes and profits taxes, subject to conditions above summarized, was \$160,000.

[10] T. D. 2836; Official statement by the Secretary of the Treasury, dated April 14, 1919; I. T. S. 1921, ¶ 1238; Reg. 45, Art. 80 (a); Reg. 45, Arts. 78-80; Letter from treasury department dated March 20, 1919; I. T. S. 1919, ¶ 3278.

[11] O. D. 493, T. B. 19-20-913.

[12] O. D. 213, T. B. 11-19-375.

would have been entitled.[13] Where, under a will, the income of an estate was to be paid to the widow for life, and upon her death to be divided equally among the surviving children, it was held that upon distribution of the estate on the death of the widow, the surviving children should not be considered original subscribers to Liberty bonds originally subscribed to by the estate. The estate and the ultimate beneficiaries are distinct entities.[14] Where a taxpayer has held at any time or times, within the taxable year Liberty Loan bonds (any issues except the first unconverted), United States certificates of indebtedness, or war savings stamps, the total interest received being equal to or in excess of the interest for one year on an aggregate principal of $5,000, credit might be taken to an amount not exceeding such amount of interest for one year on the aggregate principal of $5,000.[15] In case a taxpayer converted his Liberty bonds or Victory notes originally subscribed for from one denomination into another, or from registered bonds into coupon bonds or vice versa, he would be considered the original subscriber to the new bonds or notes for the purpose of the collateral exemptions, if the new bonds or notes were of the same issue as the ones originally subscribed for.[16]

Exemption Determined by Bonds Held at End of Year. Where a taxpayer converted bonds in the course of a year, he was deemed, for purposes of the income tax, to have held for the entire year the bonds into which his earlier bonds were converted. All amounts paid at the time of conversion of bonds for adjustment of interest were to be subtracted from amounts received at the first interest payment after conversion and only the difference between amounts received and amounts paid was required to be included in the return of taxpayer.[17] All interest accrued on 4¾ per cent Victory notes at the date of any conversion by the taxpayer into 3¾ per cent Victory notes were, for the purposes of computing net income, deemed to be interest upon 4¾ per cent Victory notes, and were entitled only to the exemptions from taxation to which interest on 4¾ per cent Victory notes were entitled. Any and all amounts received by any taxpayer from the United States by way of adjustment of

[13] O. D. 405, T. B. 8-20-752.

[14] O. D. 1000, T. B. 34-21-1779.

[15] O. D. 227, T. B. 13-20-807.

[16] O. D. 718, T. B. 45-20-1290.

[17] Letter from treasury department dated March 25, 1919; I. T. S. 1921, ¶ 1243.

accrued interest upon conversion of $4\frac{3}{4}$ per cent Victory notes into $3\frac{3}{4}$ per cent Victory notes were deemed to be interest upon $4\frac{3}{4}$ per cent Victory notes. All interest accrued on $3\frac{3}{4}$ per cent Victory notes at the date of any conversion by the taxpayer into $4\frac{3}{4}$ per cent Victory notes was for the purposes of computing net income, deemed to be interest upon $3\frac{3}{4}$ per cent Victory notes, and was entitled to the exemptions from taxation to which interest on $3\frac{3}{4}$ per cent Victory notes was entitled.[18]

LIBERTY BONDS HELD BY BANKS. The excess of the amount of bonds purchased by a bank from the government over the amount of such bonds subscribed for by the customers through the bank during the respective periods designated by the government for receiving subscriptions was regarded as being the amount of principal of bonds originally subscribed for by the bank for its own investment. Such bonds were to be listed in the return of the bank as property of the bank and the interest on such bonds was taxable income to the bank except to the extent provided in the Liberty Loan Acts and the supplements thereto. The bonds subscribed for by the customers during the subscription periods on which no default had occurred were deemed the property of the customers and were not to be listed in the return of the bank, and the interest received from the government on account of such bonds was not to be returned by the bank as income, but was to be reported in the returns of the customers.[19] A bank which takes over Liberty bonds after default by individual subscribers can not be considered an original subscriber to such bonds.[20]

Tax Exemptions of Liberty Bonds and Victory Notes Under the 1921 Law. The Revenue Act of 1921 has amended and supplemented the various Acts authorizing the issues of Liberty bonds and Victory notes and has now consolidated the exemptions appertaining to such bonds and notes. It is now provided that on and after January 1, 1921, 4% and $4\frac{1}{2}$% Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations, or associations, in respect to the interest on aggregate principal amounts thereof as follows: Until the expiration of two years after the date of the termination of the war between the United

[18] T. D. 2865.

[19] O. D. 192, T. B. 8-19-331; O. D. 16, T. B. 1-19-28.

[20] T. B. R. 28, T. B. 6-19-271.

States and the German government, as fixed by proclamation of the President on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.[21] The date of the termination of the war has been fixed by the President's proclamation as July 2, 1921.[22] The exemptions provided above are stated to be in addition to the exemptions provided in Section 7 of the Second Liberty Bond Act,[23] viz., interest on the principal amount of $5,000 in the aggregate of first 4's, first 4¼'s (issues of May 9 and October 24, 1918), second 4's and 4¼'s, third 4¼'s, fourth 4¼'s, treasury certificates and war savings certificates,[24] and also in addition to the exemption contained in § 1 (3) of the Supplement to the Second Liberty Bond Act, viz.: The interest on an amount of bonds, the principal of which does not exceed $30,000, issued upon conversion of 3½% bonds of the First Liberty Loan in the exercise of any privilege arising as a consequence of the issue of bonds of the Fourth Liberty Loan. The exemptions provided by the Revenue Act of 1921, however, are in lieu of the exemptions provided, and free from the conditions and limitations imposed by § 1 (1) and (2) if the Supplement to the Second Liberty Bond Act and § 2 of the Victory Liberty Loan Act.[25]

As a result, then, under the 1921 law, interest on all issues of Liberty bonds and victory notes are exempt from the normal tax and from the income tax on corporations.

The surtax and excess-profits tax exemptions permitted under the 1921 law (all other surtax and excess-profits tax exemptions formerly permitted being repealed as of January 1, 1921, except in the case of the 3½% Liberty bonds and the 3¾% Victory notes which carry total exemption through their respective lives) are as follows:

(1) Interest on an aggregate principal amount not exceeding $5,000 of Liberty bond issues (4's and 4¼'s) after the first, including in such later issues bonds of the First Liberty Loan converted, treasury certificates and war savings certificates (no time limit) $5,000.

(2) Interest on an aggregate principal amount of bonds (4's and 4¼'s) not exceeding $30,000 issued upon conversion of 3½% bonds of the First Liberty Loan in the exercise of any

[21] Revenue Act of 1921, § 1328.

[22] Proclamation by the President of the United States, dated November 14, 1921. See I. T. S. 1921, ¶ 3213.

[23] Act of September 24, 1917.

[24] See footnote 6.

[25] Revenue Act of 1921, § 1328 (b).

privilege arising as a consequence of the issue of bonds of the Fourth Liberty Loan (until July 2, 1923) $30,000.

(3) Interest on a principal amount of 4's and $4\frac{1}{4}$'s (until July 2, 1923) $125,000.

Providing exemption on a total principal amount until July 2, 1923 (as before in amount, but in no wise contingent on original subscription to and continued holding of bonds of the Fourth Liberty Loan, or Victory notes, and not limited to the life of the latter) $160,000.

(4) An additional exemption for three years after July 2, 1923, of the interest on a principal amount of 4's and $4\frac{1}{4}$'s $50,000.

Providing exemption during and until the expiration of the last three years of the five-year period after the termination of the war (July 2, 1921) ($20,000 more than under the 1918 law and in no wise contingent on original subscription to, and continued holding of, and not limited to life of the Victory notes, which will have matured before the three-year period begins) of the interest on a principal amount of $55,000.

(5) After the above three-year period until all Liberty bonds have matured an exemption of the interest on a principal amount of $5,000.

Liberty Bonds Carried by Banks. The amount of interest received by the bank from its customers on account of bonds carried for them (including the amount represented by any coupons retained by the bank by way of adjustment of accrued interest) constitutes taxable income to the bank, and no part of such interest is exempt from tax inasmuch as it is not interest on obligations of the United States but is interest on money advanced to the customers.[26] In cases where there have been a great many changes in the amount of Liberty bonds of the various classes, or other securities of the United States, held by a bank during the year, it will be permissible to determine the amount of interest derived from each class, in excess of the maximum exemption applicable from the books or other records of the bank. The correct amount of interest, subject to tax, received or accrued, must be shown and a statement attached to the return showing how the interest was determined.[27]

Certificates of Indebtedness Issued by Director-General of Railroads. Certificates of indebtedness issued by the director-general of railroads are held to be obligations of the United States

26 O. D. 192, T. B. 8-19-331; O. D. 16, T. B. 1-19-28.

27 O. D. 31, T. B. 1-19-43.

but not such obligations as are exempt from income, war-profits, and excess-profits taxes.[28]

War Finance Corporation Bonds. The War Finance Corporation Act makes the same provision for the exemption of interest upon bonds issued by the War Finance Corporation as is provided in the case of Second Liberty Loan Bonds; that is, interest on an amount of such bonds, the principal of which does not exceed in the aggregate $5,000 owned by any individual, partnership, corporation or association is exempt.[29] Under the 1918 Law this exemption of $5,000 was in addition to the $5,000 exemption allowed under the Liberty Loan Act of April 24, 1917, which amount includes Liberty bonds of any issue (excluding first), war savings certificates and certificates of indebtedness.[30]

Postal Savings Accounts. Interest credited to postal savings accounts upon moneys deposited in postal savings banks on or before September 1, 1917, was exempt from income tax, while interest credited upon deposits made subsequently to September 1, 1917, was liable to tax under the 1918 law.[31] The Revenue Act of 1921 exempts all interest on postal savings certificates of deposit.[32]

Food Administration Grain Corporation Notes. Interest on Food Administration Grain Corporation notes is not exempt from income tax.[33]

Interest from Federal Land Bank and National Farm Loan Association. As the Federal Farm Loan Act[34] provides that every federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of federal land banks and national farm loan associations and from interest on such farm loan bonds is not subject to the income tax.[35]

Obligations of the Possessions of the United States. Interest paid on the obligations of possessions of the United States is

[28] O. D. 206, T. B. 10-19-356.

[29] Act of April 5, 1918 (Public No. 121), § 16; O. 781, T. B. 1-19-116. See Note 6.

[30] O. D. 212, T. B. 11-19-374.

[31] Reg. 45, Art. 77.

[32] Revenue Act of 1921, § 213 (b) 4.

[33] Telegram from treasury department dated April 13, 1919; I. T. S. 1921, ¶ 1248.

[34] Act of July 17, 1916, § 26.

[35] Reg. 45, Art. 75.

exempt.[36] The interest from bonds issued by the people of Porto Rico is exempt.[37] Interest on bonds and certificates of indebtedness issued by the Philippine government is exempt.[38] Bonds issued by the military government of Santo Domingo in behalf of and payable from the revenues of the Dominican Republic while that country was under temporary military occupation by the United States are not obligations of the United States or of a possession of the United States.[39]

Obligations of Territories. Interest on the obligations of the territories, or political subdivisions thereof, is exempt.[40]

Obligations of the District of Columbia. Interest upon obligations of the District of Columbia is now exempt.[41]

Interest on the Obligations of States. The same principle which denies to a state power to raise revenue by taxation on federal property, or sources of revenue, or means of carrying on its duties, forbids taxation of state revenue for federal purposes.[42] Therefore the United States has no power under the Constitution to tax either the instrumentalities or the property of a state.[43] A municipal corporation is a portion of the sovereign power of a state and is not subject to taxation by Congress upon its municipal revenue.[44] But the exemption of state agencies does not extend to those used by the state in carrying on an ordinary private business.[45] Interest on the obligations of a state is, therefore, expressly exempt. The 1909 Law, however, being an excise tax and not an income tax, was valid although measured by income which included interest from state securities.[46] Interest received on certificates of indebtedness known as fire relief certificates, issued in the State of Minnesota, is considered interest upon the obligations of a state and not tax-

[36] Revenue Act of 1921, § 213 (b) 4; Revenue Act of 1918, § 213 (b) 4.

[37] O. D. 368, T. B. 3-20-684.

[38] O. D. 34, T. B. 1-19-46; O. D. 922, T. B. 21-21-1648.

[39] O. D. 420, T. B. 13-20-807.

[40] Revenue Act of 1921, § 213 (b) (4); Revenue Act of 1918, § 213 (b) (4). Such interest was not exempt under the 1916 Law, since the law did not expressly include territories in the exemption provision. (Revenue Act of 1916, § 4.)

[41] Such interest was not expressly included in the exemption provision of the 1916 Law. Compare Revenue Act of 1918, § 213 (b) 4; Revenue Act of 1921, § 213 (b) 4 and Revenue Act of 1916, § 4.

[42] Collector v. Day, 11 Wall. 113; Dobbins v. Erie Co., 16 Pet. 444; Ambrosini v. U. S., 187 U. S. 1.

[43] Pollock v. Farmers' Loan and Trust Company, 157 U. S. 429, 584.

[44] U. S. v. B. & O. Railroad Company, 17 Wall. 322.

[45] South Carolina v. U. S., 199 U. S. 437.

[46] Flint v. Stone-Tracy Co., 220 U. S. 107.

able.[47] It has been held that bonds issued by Michigan agricultural or horticultural societies which are authorized under the laws of that state, if duly organized as corporations, to issue interest-bearing bonds, the payment of the principal and interest of which is secured by mortgage or mortgages upon the real estate of the societies, are not obligations of a state or political subdivision thereof since neither the State of Michigan nor any political subdivision thereof obligates itself to pay either the principal or interest of these bonds.[48]

POLITICAL SUBDIVISION OF A STATE. A political subdivision denotes any division of a state or territory made by the proper authorities thereof acting within their constitutional powers for the purpose of carrying out a portion of those functions of the state or territory which by long usage and the inherent necessities of government have always been regarded as public.[49] The attorney-general has held that special assessment districts created for a public purpose, such as the improvement of streets and public highways, the provision of sewage, gas and light and the reclamation, drainage, or irrigation of land are districts for public use, and consequently political subdivisions of the state, within the meaning of the law.[50] Political subdivisions of a state or territory, within the meaning of the exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a state or territory.[51] However, a district without power to exercise

[47] O. D. 30, T. B. 1-19-42.

[48] O. D. 983, T. B. 31-21-1751.

[49] A political subdivision, according to the court in the case of Smith v. Howell, 60 N. J. L. 384, is "A division of the state, with its inhabitants organized for the public advantage and not in the interest of particular individuals or classes, the chief design of which is the exercise of governmental functions, and to the electors residing within which is, to some extent, committed the power of local government."

[50] Opinion of Atty. Gen. dated January 30, 1914. In the course of his opinion the Atty. Gen. said: "* * * where the power to levy a tax is given a district by the state, presumptively that district is created for a public use, and is exercising a public function. * * * Nor does it make any difference that the tax is measured by the benefit conferred." But he refrained from expressing any opinion whether assessment districts might not be created for a purely private purpose so as to bring them within the principles laid down in the South Carolina Dispensary case, 199 U. S. 437, rather than within those which governed U. S. v. B. & O. Railroad Company, 17 Wall. 322.

[51] Reg. 45, Art. 74; T. D. 1946.

any governmental function, created for the purpose of making some improvement, primarily beneficial to the property located in and comprising the district, is not, within the meaning of these acts, a political subdivision of the state. Obligations issued in payment for such improvement, although guaranteed by a county, municipality, or other political subdivision of the state, are not the obligations of the state or of any political subdivision thereof; but are rather the obligations of the benefited property upon which they constitute a lien. Hence, the income derived from obligations which are a direct charge against or lien upon benefited property is not exempt and must be returned as income of the recipient.[52] Where in some of the western states irrigation districts are created by an election duly called for the purpose, the county assessor assessing all property benefited on the assessment rolls of the county and collecting a tax thereon in the same manner as other taxes are collected, it is held that such districts are political subdivisions of a state and interest on their bonds is exempt.[53] Bonds issued by a municipality for public purposes in accordance with the general city charter law of the state to cover deferred installments of assessments against real estate for the cost of certain public improvements, the bonds being a lien upon all the property benefited to the extent of unpaid assessments and interest thereon and containing recitals that they are chargeable only to the particular property described therein, are held to be obligations of a political subdivision of a state, notwithstanding they were not a general liability of the city.[54] Certificates of sale issued by a county or other political subdivision of a state in connection with the sale of property for non-payment of taxes are not obligations of a state or political subdivision thereof.[55]

Interest on a claim against a city, recovered by a judgment several years after the claim accrued, is held to be interest on the obligation of a political subdivision of a state and, therefore, exempt.[56]

Where a municipality issues promissory notes, it is held that such promissory notes are the obligations of a political subdivision of a state or territory.[57]

[52] Reg. 33 Rev., Art. 84.

[53] O. D. 544, T. B. 24-20-1000.

[54] O. D. 447, T. B. 15-20-843.

[55] O. D. 327, T. B. 28-19-611; O. D. 1114, T. B. 48-21-1944.

[56] O. D. 591, T. B. 29-20-1071.

[57] O. D. 817, T. B. 8-21-1462.

Where a noninterest-bearing warrant is issued by a county in payment for services or supplies and in order that the person furnishing the services or supplies may secure from a bank the face value of such warrant the county executes an additional warrant to the bank for an amount representing interest on the warrant, it is held that the full amount of the warrant representing interest is exempt from tax inasmuch as it is interest paid by the county for the use of money paid by the bank on the warrant issued for services and supplies.[58]

A corporation is engaged in paving work for various municipalities in a state. The statutes of that state provide that municipal improvements, including pavements, shall be paid for by assessments issued to the contractor. These assessments bear interest from the date of acceptance of the work by the city engineer. The contractor receives interest from this source from the date of acceptance of the work to the date of delivery of the evidences of indebtedness. Under an agreement with a bank for advancing to it money to pay operating expenses the certificates of indebtedness were assigned to the bank. Accordingly, the corporation did not receive the certificates of indebtedness. The company did, however, receive interest which accrued from the date of acceptance of the work by the city engineer to the date of delivery of the certificates to the bank. It has been held that the interest received by the contractor for the period between the date of acceptance of the work and the date of delivery of the certificates is exempt from taxation, as the debt was an obligation exempt within the meaning of the statute. The contract of assignment to the bank did not take effect until delivery of the certificates. Consequently, the interest which accrued during the interim between acceptance and delivery was the property of the contractor.[59]

When a city acquires property for park purposes by condemnation proceedings and pays for it by special assessments upon the districts considered to be specially benefited by the proposed improvement, assessments being payable in installments over a period of 10 years, and in order to obtain funds with which immediately to compensate the owners of the property condemned, the city issues "park fund certificates" in the nature of 10-year bonds, payable out of the assessments collected, such park fund certificates are obligations of the munici-

[58] O. D. 870, T. B. 15-21-1561.
[59] O. D. 999, T. B. 34-21-1778.

pality, a political subdivision of the state, and the interest paid thereon by the city in behalf of the legally authorized assessment districts under its control is not subject to tax.[60]

MORTGAGES ASSUMED BY STATE OR MUNICIPALITY. Although interest on state or municipal bonds is exempt from the tax, yet where a state or municipality has purchased a public utility subject to a mortgage, and the mortgage retains its original character, even though the state or municipality assumes the mortgage indebtedness and pays the interest thereon, the mortgage does not become an obligation of the state or municipality within the meaning of the law and the interest thereon is not exempt.[61]

Interest on Bonds of Exempt Organizations. Although a corporation may be exempt[62] from tax on its income, yet interest on the bonds of such an organization is taxable income to the bondholder.[63]

Reporting Exempt Income. Income from United States obligations issued prior to September 1, 1917, interest on bonds of states, territories (and political subdivisions thereof), possessions of the United States and the District of Columbia, need not be included in gross income, but the amount of such securities owned by the taxpayer and the income therefrom was, under the 1918 Law, required to be stated in his return.[64] This requirement is not continued in the Revenue Act of 1921.

Accrued Interest on Obligations at Time of Purchase. Where a purchaser pays the price of the security purchased and an additional sum representing accrued interest, the amount of interest received on the next interest date should not be reported in full. The amount of accrued interest at the time of purchase represents the return of capital to the purchaser and he should deduct such amount from the interest received, and report the remainder only. The seller of the security should account in his return for the accrued interest received at the time of sale, since to him that amount is income.[65] The rule stated above does not

[60] O. D. 491, T. B. 19-20-911.

[61] Reg. 45, Art. 74; T. D. 2090.

[62] Revenue Act of 1921, § 231; Revenue Act of 1918, § 231.

[63] Letter from treasury department dated July 30, 1914; I. T. S. 1918, ¶ 1319.

[64] Revenue Act of 1918, § 213 (b) 4. See Chapter 42.

[65] Reg. 33 Rev., Art. 4; Letter from treasury department dated February 5, 1915; I. T. S. 1918, ¶ 360. In a later ruling the treasury department declined to permit the taxpayer in such a case to report all of the interest received as income and to deduct the amount of accrued interest paid at the time of purchase as an expense or as interest paid by the purchaser. (Letter dated March 8, 1915, I. T. S. 1917, ¶ 237.)

apply to coupons detached from bonds and negotiated, which themselves, after being detached, become noninterest-bearing negotiable securities. If such coupons are detached and sold, and resold, they lose their character as interest and become capital. Dealings in them are to be treated as dealings in other capital assets, and profit and loss computed accordingly. The burden is on the taxpayer to show what part of moneys paid or received by him on account of a transaction involving the sale or purchase between interest dates of interest-bearing obligations should be allocated to capital investment and what part to accrued interest. In the absence of such showing, the construction most favorable to the government should be adopted.[66] In the case of treasury certificates of indebtedness which are offered by the government at par and accrued interest and not at a discount, only the coupon interest can be considered exempt from normal tax, and from surtax to the extent provided by the act approved September 24, 1917.[67]

Interest on Bank Deposits. Interest on bank deposits or on certificates of deposit, credited to the account of the depositor by the bank, is income for the year in which the credit is made. This is true even though the bank nominally has a rule, seldom or never enforced, that it may require a certain number of days' notice in advance of cashing depositors' checks.[68]

Interest Received and Paid by Brokers. Where the customers of a brokerage house buy securities, paying only a part of the purchase price and paying interest on the balance, and the brokerage house buys such securities from others, paying only a part of the purchase price and paying interest on the balance, the brokerage house must include in its return as gross income the interest received from the customers and may deduct as interest the amount of interest it pays on such purchases.[69]

Bond Interest Paid in Scrip. Where a corporation which defaulted in the payment of its bond interest was reorganized,

[66] Sol. Op. 46, T. B. 37-20-1191.

[67] O. D. 729, T. B. 46-20-1303.

[68] Reg. 33, Art. 67; Letter from treasury department dated February 18, 1915; I. T. S. 1919, ¶ 855. Reg. 45, Art. 54. See Chapter 4, as to the case of such interest accruing to nonresident aliens.

[69] Altheimer Rawlings Investment Co. v. Allen, 248 Fed. 688, petition for writ of certiorari to United States Supreme Court denied November 11, 1918; see T. D. 2686 and T. D. 2441. This case was decided under the 1909 Law, but the principle seems to apply under the language of the present law. Interest would be deducted in full if paid on collateral the subject of sale in the ordinary course of business. The amount of such interest deductible in the case of corporations was limited under the 1916 Law. See appendix to the 1920 edition of this book.

and the new corporation issued scrip, payable at certain fixed dates, and bearing interest at 6%, in exchange for the coupons representing the defaulted interest, such scrip is held to be the equivalent of cash and taxable as interest in the hands of the recipient.[70]

Interest on Bonds Purchased at a Premium. Interest received or accrued on bonds purchased at a premium, according to the method employed in keeping books, represents income for the year in which received or accrued at the rate carried by the bonds and not at the rate which would be realized after amortizing the premium.[71]

Interest Accruing Prior to March 1, 1913. Interest due prior to March 1, 1913, could have been reduced to possession on demand prior to the incidence of the income tax. It is, therefore, capital. Interest accruing on or after that date is taxable income. Where an interest-bearing claim held on February 28, 1913, is paid in whole or in part after that date, any gain derived from the payment of the claim is taxable. The amount of such gain is the excess of the proceeds of the claim (both principal and interest) exclusive of any interest accrued since February 28, 1913, already returned as income, over the cost thereof (both principal and interest then accrued). However, the gain which is taxable where the fair market value of the claim as of March 1, 1913, is greater than the cost thereof, is the excess of the amount received over such value. No gain results where the amount received from the claim is more than the cost thereof but less than its fair market value as of March 1, 1913.[72] Where a farm was sold in 1910 under a contract calling for annual payments of principal and interest for 10 years, a deed being given in 1919, and the unpaid purchase price being secured by notes, it has been held that payments of principal received subsequent to 1910 are not subject to tax, but that for the years in which income tax laws have been in force, the vendor should have included as income any interest received which

70 O. D. 563, T. B. 26-20-1032.

71 O. D. 622, T. B. 32-20-1117.

72 Reg. 45, Art. 87, as amended by T. D. 3206, T. B. 33-21-1767. Even where interest has been in default since a time prior to March 1, 1913, and funds to pay the same have accrued since that date, it has been held that the interest represents income accrued to the owners of the bonds prior to the incident of the tax, and hence does not constitute taxable income when received thereafter. (Letter from Collector at Cincinnati dated March 16, 1915, embodying decision of the treasury department; I. T. S. 1919, ¶ 1010.) The same principle was applied by the court under the 1909 Law. (Northern Pacific Railway Co. v. Lynch, U. S. Dist. Ct., Dist. of Minnesota, T. D. 3048, T. B. 33-20-1122.

accrued subsequent to February 28, 1913, on deferred payments. Likewise he should report the interest received on the notes given for the balance of the purchase price in 1919.[73]

Discount. The excess of the face value of a so-called bank acceptance as collected at its maturity, over the amount paid therefor by a person collecting the acceptance at maturity, is not interest, but is taxable income when the face value of the acceptance is collected.[74] Profit derived from noninterest-bearing state and municipal securities purchased at a discount and held until maturity is not taxable where it clearly appears that the return from the investment in the hands of the taxpayer is due solely to the compensation received from the state or municipality in lieu of interest for the use of the taxpayer's money. In no case may such exemption exceed the total discount at which the securities were originally sold by the state or municipality.[75] The realized discount on a sale of municipal securities prior to maturity can not be treated as compensation "in lieu of interest" paid by a municipality, but is profit subject to tax. Only the holder of the note at maturity is entitled to treat the realized discount as income exempt from tax.[76] Inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount) any person selling municipal bonds for an amount in excess of the cost of the bonds to him realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount. If, therefore, a bank sells at $98 municipal bonds issued at $94.50 and purchased by it at $96.10 it will derive a taxable profit of $1.90 on each bond sold. If, however, it holds the bonds to maturity and receives $100, the difference between the purchase price of the bonds and the amount received or $3.90 will represent exempt income to it.[77]

Where a municipality borrows money from a bank with which to pay its bills covering expenses, the promissory notes given for the money borrowed being issued at a discount, and it being also provided that if the notes are not paid when due they will also draw interest from maturity until paid, it has been held

[73] O. D. 646, T. B. 35-20-1165. The English courts have followed the same rule in dealing with such contracts; see Hudson's Bay Co. v. Thew, Gt. Br. Tax Cases, Vol. VII, Pt. II, p. 206.

[74] O. 1024, T. B. 16-20-865.

[75] O. D. 647, T. B. 35-20-1166, reversing O. D. 238, T. B. 13-20-416; O. D. 774, T. B. 2-21-1396.

[76] O. D. 774, T. B. 3-21-1396.

[77] O. D. 762, T. B. 1-21-1369.

that both the discount and the interest on the principal of the note after maturity are exempt from income and profits taxes in the hands of the bank as interest upon the obligations of a political subdivision of a state.[78] Where a noninterest-bearing warrant is issued by a county in payment for services or supplies for an amount which represents the purchase price of the services or supplies plus interest on such amount until the date of maturity of the warrant and the person to whom such warrant is issued discounts it at a bank in order to secure money thereon, the matter of the discount is a transaction wholly between the party to whom the warrant is issued and the bank, and the discount is not free from tax. This ruling applies whether negotiations for discounting such warrant are made by the county, or by the owner of the warrant.[79]

Rent. Rent, like all other income, may be received in cash, in kind, or in the equivalent of cash. The questions arising under the income tax law with regard to rent usually relate to the taxable period for which rent income is to be reported or to situations involving the payment of rent in some form other than cash. The following paragraphs deal with the latter kind of question:

VALUE OF IMPROVEMENTS MADE BY TENANT. Where, under the terms of a lease a tenant agrees to erect a building or to expend during the period of the lease a certain fixed sum in making improvements upon the freehold of the lessor, the building or permanent improvement becomes a part of the realty unless otherwise agreed upon between the contracting parties. The treasury department has modified its previous ruling that improvements made by a tenant are income to the lessor at the expiration or termination of the lease and has now ruled that when buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If, for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the

[78] O. D. 856, T. B. 13-21-1530.
[79] O. D. 870, T. B. 15-21-1561.

time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the expiration of the lease the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction will be based on the cost or the value subject to the lease, as of that date, whichever is lower, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance.[80] The following example has been given by the treasury department to illustrate the proper construction of the above ruling:

A, in 1915, leases certain land to B for 20 years. B agrees, in part consideration for the lease, to erect on the leased ground a building, specifications agreed upon, of an estimated life of 25 years and to cost $50,000, which building is not to be subject to removal by B. The building is completed in 1920.

A realizes income in 1920, the year in which title to the building passes. The measure of the income is the present value to A of the building, of an estimated life of 25 years and cost of $50,000, the use and enjoyment of which is postponed for 15 years. The depreciated value of the building at the termination of the period of the lease will be approximately $20,000—that is, cost less depreciation sustained. The income of A, then, is the discounted value of $20,000 receivable at the end of 15 years. If market value reflects intrinsic value, this amount should equal the difference between the value of the land free from the lease without the buildings and the value of the land subject to the lease with the building. However, any other evidence available should be considered in determining this present worth to the

80 Reg. 45, Art. 48, as amended by T. D. 3206, T. B. 33-21-1767. See also Cryan v. Wardell, 263 Fed. 248; Miller v. Gearin, 258 Fed. 225. "A ground rent" under a Virginia lease, should be returned as rent (O. D. 1089, T. B. 45-21-1905).

taxpayer of the legal title to the encumbered building. Since A has included in income only the depreciated value of the building, he is entitled to a depreciation deduction with respect to such building only for the years after the termination of the period of the lease when A has come into possession. This depreciation deduction to which A is entitled for 1935 and subsequent years should be computed on a basis of the estimated remaining life of the building and a "cost" value equal to the market value placed on the encumbered building by A in the year of its erection, i. e., the annual depreciation deduction for 1935 and subsequent years will be the quotient obtained by dividing (a) the value of the improvements to A as determined by him when the same completed became part of the realty, by (b) the number of years in the estimated remaining life of the improvements from the termination of the lease.

In any case in which the term of the lease is greater than the estimated life of the improvement no income should be accounted for by the lessor at the time of the passage of title. Also if the improvements will have no value at the termination of the lease, as is often the case in mining leases, no income is realized by the lessor.[81]

PAYMENTS BY TENANT ON BEHALF OF LANDLORD. In general, sums paid by a tenant for the use of property, although to another than the landlord, are properly to be regarded as rent and constitute income of the landlord.[82] Where under the terms of a lease a tenant pays or incurs liability for taxes, repairs or interest for and on behalf of the landlord, such payments constitute income to the landlord. The theory covering these transactions is that the tenant is acting merely as agent for the landlord in making the payments. The expenses are deductible by the landlord, and the amounts used to defray such expenses must be reported by the landlord as his income.[83] Such payments may be deducted by the tenant as rent in the year in which they are paid.[84]

RECEIPT OF RENT IN KIND. Where rent is received in the form of produce, as for instance, a share of the crops of a farm, and such produce or crops have no definite market value, the amount realized on the sale of such share must be included as income in the year in which the share is disposed of or reduced to

[81] M. 2714, T. B. 8-21-1474.

[82] Reg. 45, Art. 48.

[83] Reg. 33 Rev., Art. 4; T. D. 3062, T. B. 37-20-1198, amending Reg. 45, Arts. 48, 109 and 164.

[84] Reg. 33 Rev., Art. 8.

money or its equivalent. Where board or lodging is given as the equivalent of rent, the value of such board or lodging is required to be included.

Constructive Receipt of Rent. In a case decided under the 1909 Law, four railroad companies formed a corporation for the purpose of securing for themselves terminal services. All the stock of the terminal company was held by the four railroad companies in equal parts and all its operating expenses were paid by the railroad companies *pro rata*. In order to finance the terminal company, a large sum of money was necessary and the railroad companies agreed to pay the annual interest and sinking fund requirements of a loan from a trust company to the terminal company in equal parts, the loan being secured by a mortgage on the property of the terminal company. The property was to become the unencumbered property of the terminal company on final payment of the mortgage indebtedness; the payments by the railroad companies could not be said to be voluntary, but were in accordance with certain formal agreements with both the terminal company and the trust company. The court held that the amount of interest paid by the railroad companies direct to the trust company was income to the terminal company. The railroad companies made use of the facilities and services of the terminal company in two ways: First, by the use of its property; and second, through the services of its employees. The second was paid for by the *pro rata* contribution to operating expenses. The consideration for the use of the property was the payment of the interest into the sinking fund. Such payments were in lieu of compensation for the enjoyment of the property used and were in the nature of rent received by the terminal company and to be accounted for in its returns as such.[85]

In another case, a corporation leased all of its property to another corporation for a term of years in consideration of an annual rental, payments to be made semi-annually in each year during the term of the lease. The lessee company was the owner of a large part of the capital stock of the lessor company and it was the practice of the former company to pay the annual rental, not directly to the lessor company, but to remit to the latter company's stockholders on the days when the rental was due their proportion of such rental based on the amount of each stockholder's stockholding in the lessor corporation. Had the lessee corporation paid the entire rental to the lessor corpo-

85 Houston Belt & Terminal Co. v. U. S., 250 Fed. 1.

ration, it would have received back as dividends the difference between the total rental and the amount remitted to the other stockholders of the lessor corporation. The treasury department held that, in effect, the lessee corporation paid out the entire rental each year and as a stockholder had returned to it a portion of such amount as a dividend on its holdings of stock in the lessor corporation, and the mere fact that it did not actually pay to the lessor corporation the full amount of such rental and then have formally paid to it by the latter company a dividend did not change the substance of the transaction. The lessor corporation was in constructive receipt of the entire rental, notwithstanding the fact that the form of receiving it and paying it out again as dividends was not gone through.[86]

Royalties. Amounts received as royalties are income in the taxable year of receipt, actual or constructive, or in the taxable year in which they accrue, accordingly as the taxpayer reports his income on the basis of receipts or accruals. Royalties fall under the broad expression "income derived from sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also gains or profits and income derived from any source whatever." In the provisions of the Revenue Act of 1921 imposing the tax on nonresident aliens, "royalties from property located in the United States" are expressly included in the gross income of such taxpayers.[87]

ROYALTIES FROM MINES. It has been contended that royalties received under leases of oil, gas, and solid minerals are in fact not income but payments of installments on the purchase price of the natural deposit. The nature and effect of such leases has been the subject of some difference of opinion in the courts. It has been held that the leases are leases in name only; that they are in fact conveyances of the ore body or oil and gas in place as a part of the realty; that the so-called royalties merely repre-

[86] A. R. R. 589, T. B. 30-21-1747. See also Renselaer & Saratoga R. R. Co. v. Irwin, 249 Fed. 726, writ of certiorari denied, 246 U. S. 671; Northern Co. v. Lowe, 250 Fed. 856; Anderson v. Morris & Essex R. R. Co., 216 Fed. 83.

[87] Revenue Act of 1921, § 217 (a) 4. Revenue Act of 1921, § 213 (a). It has been held that royalties received by a corporation in accordance with a contract by which it has assigned the patent rights to manufacture machines, etc., are income and should be so accounted for (Reg. 33 Rev., Art. 113; letter from treasury department dated January 24, 1916; I. T. S. 1918, ¶ 1262) and that royalties paid to a proprietor by those who are allowed to develop or use property or operate under some right belonging to such proprietor are also to be accounted for as income. (Reg. 33 Rev., Art. 4.)

sent payments for so much land and are in no just sense income, but mere conversions of the capital.[88] On the other hand, it has been held that leases of solid mineral rights do not constitute a sale of any part of the land or a sale of ore in place, and that the royalties payable constitute the rents and profits of the land.[89]

[88] See Hook v. Garfield Coal Co., 112 Ia. 210, 83 N. W. 963; Wilson v. Youst, 43 W. Va. 826, 28 S. E. 781; Manning v. Frazier, 96 Ill. 279; Spooner v. Phillips, 62 Conn. 62, 24 Atl. 524; Wilcox v. Middlesex County, 103 Mass. 544; Plummer v. Hillsdale Coal etc. Co., 163 Pa. 483, 28 Atl. 853; Barnsdall v. Bradford Gas Co., 225 Pa. 338, 74 Atl. 207.

[89] T. D. 2152; Von Baumbach v. Sargent Land Co., 242 U. S. 503; U. S. v. Biwabik Mining Co., 247 U. S. 116; Stratton's Independence v. Howbert, 231 U. S. 399, 34 Sup. Ct. 136; Chemung Iron Co. v. Lynch, 269 Fed. 368; State v. Evans, 99 Minn. 220, 108 N. W. 958; Boeing v. Owsley, 122 Minn. 190, 142 N. W. 129; State v. Royal Mineral Association, 132 Minn. 232, 156 N. W. 128; Reg. v. Westbrook, 10 Q. B. 178, 205, 22 Eng. Rul. Cas. 623. For a thorough discussion of the first three cases cited above see the discussion of the subject of depletion by lessees under prior laws in Chapter 27. This discussion will throw light upon the subject of royalties from mines. The leases involved in the Sargent case were leases of iron ore lands and they contained substantially the following provisions: (1) that the owners leased to the lessees exclusively all the lands described for the purpose of exploring for, mining, and removing the ore which might be found therein for the period of fifty years; (2) the lessees were given the exclusive right to occupy and control the leased premises and to erect all necessary buildings, etc., thereon, (3) right was reserved to the lessors to enter for the purpose of ascertaining the amount of ore mined and removed and of making observations, etc.; (4) the lessees agreed to pay in most cases a certain price per ton for all ore mined and removed; (5) the lessees agreed to mine and ship a specified quantity of ore each year in default of which they agreed to pay the lessors for a minimum amount; (6) the lessees agreed to pay taxes and to keep the property free from encumbrances; (7) the lessors reserved the right to terminate the lease upon default of the lessees; (8) the lessees had the right to terminate the leases upon sixty days notice. The Supreme Court held that moneys received under these leases did not represent, in whole or in part, conversion of the investment of the lessors from ore into money, but on the contrary they represented the rents and profits of the land to be accounted for as income by the recipient lessors. In the Biwabik case the leases involved contained substantially similar provisions and the lands leased contained deposits of iron ore. The court expressly stated in this case that its findings in the Sargent case left "little room to suppose that this court made its decision concerning the rights of the lessor influenced by the fact that the land itself was the chief thing, and the ownership of it after the exhaustion of the minerals one of the controlling reasons in reaching the conclusion announced in that case." The court repeated its decision in the Sargent case that the lessee was in no legal sense the purchaser of ore in place. Owing to the migratory, fugitive, and volatile character of oil and gas the rights and ownership therein are to be determined according to special rules and not according to the rules which prevail in the case of ore. coal and other solid minerals. (Ohio Oil Co. v. Indiana, 177 U. S. 190;

It has been held under the 1913 and 1916 Laws that a Pennsylvania mining lease containing the provisions indicated in the footnote below does not constitute a sale of the coal in place and that royalties received thereunder are income to the lessors.[90] Income from oil royalties must be returned in the taxable year received, even though the title to the producing land is in litigation.[91] When land purchased in 1914 and having no mineral rights value at the time of purchase, is subsequently leased on a royalty basis for oil and gas development, amounts received from the sale of interests in such royalty have been held to be income for the year of receipt, subject to proper adjustment on account of depletion sustained.[92]

ROYALTIES FROM PATENTS AND COPYRIGHTS. Royalties on patents are income.[93] Taxpayers receiving royalties from patents, copyrights, or other similar forms of property, may deduct from each payment a proportionate part of the cost thereof as representing a return of capital. This is more fully discussed in a subsequent chapter.[94]

Brown v. Spilman, 155 U. S. 665.) It may be that royalties upon oil and gas leases are for this reason distinguishable from royalties upon solid mineral leases, but the point has never been expressly determined with reference to the income tax.

[90] S. 1365, T. B. 18-20-900. The provisions of the lease under consideration were as follows: (1) To demise, lease and let to the lessee all coal in, upon and under certain lands owned by the lessor. (2) The lessee was given the right to mine, remove, and dispose of the coal. (3) The lessor retained the privilege at any time after the expiration of the first 10 years of the lease to sell the leased property upon giving 6 months' notice to the lessee and affording the lessee an opportunity to purchase the property. (4) The lease was not to be assigned by the lessee without the consent of the lessor. (5) The lessor retained absolutely the right to sell the property subject to the terms of lease. Upon termination of this lease, a new lease agreement was made containing, among other provisions, the following: (1) Term of lease, 10 years. (2) Lessee to mine and remove as much coal as possible by reasonably diligent mining operations. (3) The lessee agreed not to assign the lease without consent of the lessor, but had the right to sublet portions of the surface without consent of the lessor. (4) Upon failure of the lessee to comply with all conditions of the agreement, the lessor had the right to declare a forfeiture of the unexpired portion of the lease.

[91] O. D. 825, T. B. 9-21-1477. If any part of the royalty income is ordered by the court to be paid over to another, any tax previously paid thereon will be credited or refunded upon presentation of the proper claim. This ruling is criticised in Chapter 33. See also O. D. 971, T. B. 28-21-1723.

[92] O. D. 644, T. B. 35-20-1163.

[93] Reg. 45, Art. 48.

[94] See Chapter 26.

CHAPTER 19

INCOME FROM DIVIDENDS

The law expressly states that the gross income of a taxpayer shall include gains, profits and income derived from dividends.[1] Important amendments made by the Revenue Act of 1921 upon the subject of dividends are (1) the recognition that stock dividends are not constitutionally taxable, (2) the statement conclusively of certain provisions formerly stated as presumptions, and (3) the statutory enactment of the rule that a taxable corporate distribution shall be taxable as of the date when the cash or other property distributed is made unqualifiedly subject to the demand of the distributee, and (4) the two amendments indicated in the next paragraph. A change is made necessary in the definition of dividends by the abolition of personal service corporations as of December 31, 1921, and the presumption contained in the 1918 Law as to dividends distributed during the first 60 days of a taxable year is made inapplicable after December 31, 1921, as of which date the excess-profits tax, to which this presumption related, is repealed.

Definitions. A notable change made by the 1921 Law is the provision permitting *accretions in the value* of property accrued prior to March 1, 1913, as well as earnings and profits accumulated prior to that date, to be distributed free from tax after earnings and profits accumulated since February 28, 1913, have been distributed.[2] In accordance with the decision of the Supreme Court[3] stock dividends are expressely stated not to be taxable dividends.[4] As defined in the Revenue Act of 1921, the term "dividend" (with one exception where it is used in connection with dividends paid on policies by insurance companies) means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913, except a distribution made by a personal service corpora-

[1] Revenue Act of 1921, §§ 213 (a) and 233; Revenue Act of 1918, §§ 213 (a) and 233. The Revenue Act of 1916 provided that subject only to such exemptions and deductions as were thereinafter allowed, the *net* income of a taxpayer should include gains, profits and income derived from dividends (Revenue Act of 1916, § 2 (a)).

[2] Revenue Act of 1921, § 201 (b).

[3] Eisner v. Macomber, 252 U. S. 189.

[4] Revenue Act of 1921, § 201 (d).

tion out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922.[5] The term "dividend", as used in the Revenue Act of 1918 (with the same exception noted above) was defined therein to mean (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal-service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[6] Under the 1918 Law amounts distributed in the liquidation of a corporation were expressly required to be treated as payments in exchange for stock or shares, and any gain or profits realized thereby were taxed to the distributee as other gains or profits.[7]

It is to be noted that under these definitions any distribution in the ordinary course of business, though extraordinary in amount, which is made by a corporation of earnings or profits accumulated since February 28, 1913, is a dividend; it need not necessarily be called a dividend. There need be no formal declaration.[8] On the other hand, if the distribution is not out of earnings or profits accumulated since February 28, 1913 (and prior to January 1, 1918, or subsequent to December 31, 1921, in the case of personal service corporations), it does not become a dividend within the meaning of the law by reason of the fact that it is called a dividend by the corporation making the distribution.[9]

DIVIDENDS FROM ASSOCIATIONS. Since associations, joint-stock companies and insurance companies (whether incorporated or not) are treated as corporations and limited partnerships may be so treated,[10] the net earnings of such organiza-

5 Revenue Act of 1918, § 201 (a). After January 1, 1922, personal service corporations are taxed as other corporations.

6 Revenue Act of 1918, § 201 (a); Reg. 45, Arts. 1541 and 1543. It will be noted that this definition, as compared with the 1916 Law, aside from its provisions for personal service corporation distributions omitted the words, "or ordered to be made"; substituted the word "accumulated" for "accrued"; and also expressly included distributions made "in other property." See Revenue Act of 1916, § 31 (a), Reg. 33 Rev. Art. 106.

7 Revenue Act of 1918, § 201 (c); Reg. 45, Art. 1548.

8 See O. 932, T. B. 25-19-579.

9 Reg. 45, Art. 1543.

10 The definition of "corporations" includes "associations, joint-stock companies, and insurance companies" (Revenue Act of 1921, § 2; Revenue Act of 1918, § 1; see also T. D. 2152; T. D. 2137).

tions when distributed should be considered dividends.[11] The recipient of profits or associations or limited partnerships should, therefore, ascertain whether the asociation or partnership is paying the tax as a corporation and in such event should treat any part of the net profits of the association received by him as dividends.

EXCESSIVE COMPENSATION. Payments of compensation to the stockholding officers or employees of a corporation, to the extent that such payments are in excess of a reasonable return for services rendered, may be regarded as dividends, as indicated in another chapter.[12]

DIVIDENDS IN THE FORM OF ROYALTIES. A royalty paid by a corporation to one of its officers, who is also majority stockholder, for the use of a patent upon an article manufactured and sold by the corporation, if in excess of a reasonable amount, taking into consideration all the facts in the particular case will represent a distribution of profits and will be taxable to the recipient as dividends.[13]

COMPROMISE OF PREFERRED DIVIDENDS. Preferred stockholders whose dividends are in arrears have no enforceable claim against the corporation unless and until a dividend be declared by the directors and consequently are not "creditors". A payment or settlement pursuant to the compromise by corporate directors of accumulated dividends on preferred stock, the payment or settlement consisting partly of cash, partly of shares of preferred stock, and partly shares of common stock, has been held to be a dividend within the meaning of the Massachusetts Income Tax Law, since the money and stock are paid from or based upon earnings.[14]

TAXES PAID FOR SHAREHOLDERS TO BE CONSIDERED AS DIVIDENDS. Where a corporation, such as a bank, pays taxes assessed upon the respective interests of its shareholders, under laws which require the corporation to pay such taxes on behalf of its shareholders, the *pro rata* amount so paid on his shares was required under the 1918 Law to be reported by the stockholder as a dividend. The same amount might also be deducted as a tax of the stockholder paid for him by the corporation as his agent. The net result of reporting such amount as a dividend, and claiming the same amount as a deduction, was

[11] See Chapter 8.

[12] See Chapter 22. See also Chapter 15.

[13] O. D. 440, T. B. 14-20-835.

[14] Wilder v. Trefry (Mass.), 125 N. E. 689. See, however, p. 531 as to dividends paid in stock.

that the amount of tax is offset against the stockholder's income from other sources in assessing the normal tax.[15] Under the present law such taxes are deductible by the corporation and the stockholder may not deduct them.[16]

Distributions Which Are Not Dividends. A distribution by a corporation out of earnings or profits accumulated, or increase in value of property accrued, prior to March 1, 1913, or out of any assets except earnings or profits accumulated since February 28, 1913, is not a dividend within the meaning of the statute. A distribution by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922, is not a dividend. A distribution out of earnings or profits accumulated, or increase in the value of property accrued, before March 1, 1913, is free from tax as a dividend; out of assets other than earnings or profits accumulated since February 28, 1913, may or may not be free from tax, according as each stockholder receives more or less than he paid for his stock. However, if such stock was acquired prior to March 1, 1913, and the fair market value as of such date was greater than the cost thereof and less than the sum received in distribution, the amount which is taxable is the excess over such market value as of March 1, 1913, of the sum received in the distribution, but no gain is recognized if the amount received in distribution is more than the cost, but less than the fair market value of the stock on March 1, 1913. In the case of a personal service corporation a distribution out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922, is taxed to the stockholders as though they were partners.[17] Where a corporation offers its employees the opportunity to purchase shares of its stock, and the title to the stock remains in the corporation until it is fully paid for, it is held that the so-called dividends accredited to the account of the employees purchasing the stock as part payment for the stock are not in fact dividends, as dividends cannot legally be declared on unissued or treasury stock. The amounts so credited, which are measured by the dividends declared on the outstanding stock, constitute additional compensation to the employees and are taxable as such.[18]

[15] See Chapter 24.

[16] Revenue Act of 1921, §§ 234 (a) 3, 214, (a) 3.

[17] Revenue Act of 1921, § 201; Reg. 45 Art. 1543, as amended by T. D. 3206, T. B. 33-21-1767.

[18] O. D. 763, T. B. 1-21-1370; O. D. 791, T. B. 6-21-1426.

Dividends on Life Insurance Policies. It is a custom of insurance companies to return each year a portion of the premium paid by the insured. The amount so returned is usually designated as a "dividend" and is either received in cash by the insured or applied by him to the reduction of the next annual premium. The law expressly provides that amounts received as a return of premiums paid by the taxpayer is not income.[19] Where, however, dividends are received on a paid-up policy their amount should be considered the same as dividends from corporations,[20] unless, of course, the dividend was not paid by the insurance company out of earnings or profits accumulated since the incidence of the tax.

Dividends from Co-operative Associations. Dividends paid by co-operative associations, acting as sales agents for farmers or others, in the nature of a periodical refund or rebate to members or prospective members or patrons generally, are wholly different from ordinary distributions based upon stockholdings and may be excluded from gross income by their recipients. Any profits of such associations made from nonmembers and distributed to members in the guise of rebates, are, of course, subject to tax.[21]

Dividends from Federal Reserve Bank. The Federal Reserve Act of December 23, 1913, provides that Federal Reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Such exemption attaches to and follows the income derived from dividends on stock of Federal Reserve banks in the hands of the stockholders, so that the dividends received on the stock of Federal Reserve banks are not subject to the income tax. Dividends paid by member banks, however, are treated like dividends of ordinary corporations.[22]

Dividends and Interest from Federal Land Bank and National Farm Loan Association. As the Federal Farm Loan Act of July 17, 1916, provides that every Federal Land bank and every National Farm Loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that Farm Loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on

19 Revenue Act of 1921, § 213 (b) 2; Revenue Act of 1918, § 213 (b) 2.

20 T. D. 2137.

21 Reg. 45, Art. 522; T. D. 2737. See Chapter 13.

22 Reg. 45, Art. 76; Federal Reserve Bulletin, April 1, 1916.

stock of Federal Land banks and National Farm Loan associations and from interest on such Farm Loan bonds is not subject to the income tax.[23]

Extent to Which Dividends are Taxable. The extent to which dividends are taxable depends upon the status of the paying corporation and upon the status of the recipient of the dividends. As a general rule the income from dividends is subject only to the surtax. However, dividends from (1) domestic corporations taxable only with reference to income from sources within the United States and (2) foreign corporations 50% or less of whose income for the three-year period ending with the close of the taxable year preceding the declaration of dividends was from sources within the United States are liable to the normal tax as well as the surtax.[24]

DIVIDENDS PAID BY DOMESTIC CORPORATIONS.[25] Under the present law, dividends paid by domestic corporations (except domestic corporations taxable only with reference to income from sources within the United States and personal service corporations, as indicated in a paragraph following) if received by an *individual*, are subject only to the surtax, the amount thereof being allowed as a credit for purposes of the normal tax.[26] If the recipient is a *nonresident alien*, the credit of such dividends for purposes of the normal tax will be allowed only if such recipient files a return of his total income received from all sources within the United States in the manner prescribed by the statute.[27] Such dividends are deductible by a *corporation, domestic or foreign*.[28]

[23] Reg. 45, Art. 75; Reg. 33 Rev., Art. 86. Revenue Act of 1918, § 231 (13).

[24] Revenue Act of 1921, § 216 (a).

[25] Under the 1918 Law dividends paid by a domestic corporation liable to income tax or by a personal service corporation out of earnings or profits upon which income tax had been imposed were not subject to the normal tax if received by an *individual* (Revenue Act of 1918, § 216 (a)). If the recipient was a *non-resident alien*, the credit of such dividends for normal tax purposes was allowed only if he filed a return of total income from all sources within the United States (Revenue Act of 1918, § 217). If such dividends were received by a *corporation, domestic or foreign*, the amount thereof was allowed as a deduction (Revenue Act of 1918, § 234 (a) 6, (b).) Dividends paid to non-resident alien individuals or to non-resident foreign corporations by domestic corporations doing no business and owning no property in the United States were not taxable at all (Reg. 45, Art. 92).

[26] See Revenue Act of 1921, §§ 216 (a), 262.

[27] Revenue Act of 1921, §§ 216 (a), 217 (g).

[28] Revenue Act of 1921, § 234 (a) 6. Under the 1913 Law corporations were not permitted to deduct amounts received as dividends from corporations subject to the income tax. This was likewise true of the 2% tax im-

DIVIDENDS PAID BY PERSONAL SERVICE CORPORATIONS.[29] Under the 1921 Law dividends paid by personal service corporations out of earnings or profits upon which income tax has been imposed are taxable as stated in the preceding paragraph. The special class of corporations known as personal service corporations is abolished by the 1921 Law as of December 31, 1921. Therefore, dividends paid by a personal service corporation are now taxable as stated in the preceding paragraph, unless they are paid out of earnings or profits accumulated between December 31, 1917, and January 1, 1922.[30]

DIVIDENDS PAID BY FOREIGN CORPORATIONS. The present law contains a substantial departure from the 1918 Law in its treatment of dividends paid by foreign corporations. Foreign corporations are now divisible in this respect into (1) those which derive more than 50% of their gross income for the three-year period ending with the close of the taxable year preceding the declaration of dividends (or for such part of such period as the corporation has been in existence) from sources within the United States and (2) those which derive 50% or less of such gross income from sources within the United States. Dividends paid by foreign corporations included in (1) above are subject only to the surtax if received by an *individual,* the amout thereof being allowed as a credit for purposes of the normal tax. If the recipient is a *nonresident alien,* the credit of such dividends for normal tax purposes will be allowed only if the nonresident alien files a return of total income received from all sources within the United States in the manner prescribed by the statute. If such dividends are received by a *corporation, domestic or foreign,* the amount thereof is allowed as a deduction. A foreign corporation, however, in order to be entitled to the deduction, must file a return in the manner indicated in the case of non-resident alien individuals.[31] Dividends paid by foreign corporations included in (2) above are subject to the normal tax, as well as the surtax, in the hands of citizens and residents, since they may not be credited for purposes of the normal tax of citizens and residents.

posed by the 1916 Law, but for the purpose of the 4% tax imposed by the 1917 Law the amount of such dividends was permitted as a credit. (Revenue Act of 1917, § 3; Reg. 33 Rev., Art. 105.)

[29] Under the 1918 Law, dividends paid by personal service corporations out of earnings or profits upon which income tax had been imposed, that is, earnings or profits accumulated between February 28, 1913, and January 1, 1918, were liable to tax as stated in footnote 25. (Revenue Act of 1918, §§ 216 (a), 234 (a) 6, and 217.)

[30] Revenue Act of 1921, §§ 201 (a), 218 (d).

[31] Revenue Act of 1921, §§ 216 (a), 234 (a) 6, (b) 217.

In the case of *nonresident aliens* or *foreign corporations* they do not constitute income from sources within the United States.[32] When received by a *domestic corporation* dividends paid by foreign corporations, included in (2) above, are not deductible.[33]

LEGAL AND BENEFICIAL OWNERS OF STOCK ON WHICH DIVIDENDS ARE PAID. The fact that an individual may not have legal title to the stock on which dividends are declared does not alter the rules stated in the preceding paragraphs. If he is the actual beneficial owner, the amount which is received by a trustee in the form of dividends may be treated as dividends by a beneficiary in making his return, and, similarly, dividends received by a partnership may be treated as dividends received by the individual partners.[34] When dividends are received by one who is not the actual owner of the stock, but is the owner of record, he is not required to include the amount thereof in his own return[35] but proceeds in accordance with the rules stated elsewhere in this book.[36]

Distribution in Liquidation Under the 1918 Law. The Revenue Act of 1918 provided that "amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits."[37] Under

[32] Revenue Act of 1921, §§ 217 (a) 2, 216 (a).

[33] Revenue Act of 1921, § 234 (a) 6. The rule stated in the paragraph above classifies foreign corporations upon a different theory from that which underlay the classification under the 1918 Law. Under that law, foreign corporations were divisible into (1) those deriving no income from sources within the United States and (2) those deriving income from sources within the United States, however small the amount thereof. Dividends paid by corporations included in (1) were treated in the same manner as dividends paid by foreign corporations included in class (2) in the text above; dividends paid by foreign corporations included in class (2) were treated in the same manner as dividends paid by corporations within class (1) in the text above (Revenue Act of 1918, §§ 216 (a), 234 (a) 6, 217; Reg. 45, Art. 92; Letter from treasury department dated June 9, 1919; I. T. S. 1921, ¶ 1661). This classification superseded the rule laid down for purposes of the excess-profits tax in 1917 to the effect that if a foreign corporation paid income tax on a part of its net income its dividends should be treated to that extent as dividends paid by domestic corporations (Reg. 41, Art. 27).

[34] Revenue Act of 1921, §§ 218, 219; Revenue Act of 1918, §§ 218, 219; see U. S. v. Colby, 251 Fed. 982, affirmed, 258 Fed. 27. See Chapters 6 and 8.

[35] Letter from treasury department dated November 21, 1916; I. T. S. 1918, ¶ 272.

[36] See Chapter 5.

[37] Revenue Act of 1918, § 201 (c).

this provision of law the treasury department ruled that so-called liquidation or dissolution dividends were not "dividends," and amounts so distributed, *whether or not including any surplus earned since February 28, 1913,* were regarded as payments for the stock of the dissolved corporation. Any excess so received over the cost of his stock to the stockholder constituted income to such stockholder. However, if such stock was acquired prior to March 1, 1913, and the fair market value as of such date was greater than the cost but less than the amount so distributed, the taxable income was the excess over such fair market value of the amount received, but no gain was recognized if the amount received, although more than cost, was less than the fair market value of the stock on March 1, 1913. A distribution in liquidation of the assets and business of a corporation, which was a return to the stockholder of the value of his stock upon a surrender of his interest in the corporation, was distinguished from a dividend paid by a going corporation out of current earnings or accumulated surplus when declared by the directors in their discretion, which was held to be in the nature of a recurrent return upon the stock.[38] It was held under

[38] Reg. 45, Art. 1548, as amended by T. D. 3206, T. B. 33-21-1767. See also Reg. 45, Arts. 1541 and 1543; A. R. R. 67, T. B. 17-20-877. The treasury department has held to the same effect under the 1916 Law. (See S. 971, T. B. 2-19-141; T. B. R. 71, T. B. 22-19-530. This ruling was founded largely upon the distinction drawn by the United States Supreme Court in the cases of Lynch v. Turrish, 247 U. S. 221, and Lynch v. Hornby, 247 U. S. 339. It is to be noted that the question in both these cases was whether earnings or profits accumulated prior to March 1, 1913, should be considered as dividends. The question was not: Shall earnings or profits accumulated *subsequent* to March 1, 1913, be considered as dividends? In determining the former question the Supreme Court drew a distinction according to whether or not the distribution was a dividend in ordinary course or a final dividend in liquidation. This distinction does not affect the answer to the second question. The issue in the Turrish and Hornby cases was whether certain earnings or profits were essentially *capital* or *income* for tax purposes, whether they were taxable as income or exempt as capital. On the other hand, the question arising in the interpretation of § 201 of the Revenue Act of 1918 pertains to the *character* of the taxability of certain earnings and profits. The Supreme Court did not hold in the Turrish case that corporate gains and profits accumulated prior to March 1, 1913, *are not* "dividends" if paid to a stockholder upon a winding up of the affairs of a corporation; it declared that such earnings or profits had become capital and were exempt therefore from tax when distributed. It did not hold in the Hornby case that corporate gains and profits accumulated prior to March 1, 1913, *are* dividends because they were paid to a stockholder by a corporation continuing in business or a going concern; it declared that such earnings or profits did not come into fruition as income to *the stockholder* until by virtue of an exercise of affirmative discretion on the part of the

the 1918 Law, however, that a distribution of earnings or profits prior to any vote or resolution providing for liquidation was an ordinary, not a liquidating, dividend, even though the stockholders subsequently voted to go into liquidation and to distribute

directors they were *declared*, that is, until they were separated from the corporation's general assets and the stockholder's interest was transformed from an inchoate and contingent interest in them to a definite and fixed share. It will be argued that a distribution which would have been a "dividend" under the Hornby case was held not to be a "dividend" in the Turrish case, solely because it was made upon the liquidation of the paying corporation and that therefore the essence of what would ordinarily be a "dividend" under the 1918 Law is changed by the same token. This argument is based upon the fallacy that the taxability of earnings or profits accumulated since the incidence of the tax is to be determined according to the same differentiation applying in the case of earnings or profits accumulated prior thereto. But, as stated above, the Turrish and Hornby cases divided on the question when, with reference to the incidence of the tax, a *distribution became income.* They did not settle the question: What kinds of income are certain concededly taxable earnings or profits? The court was not attempting in the Turrish and Hornby cases to distinguish between "dividends" and other distributions. It was drawing a line between capital and income, income received prior to March 1, 1913, having the status of capital. Although the Commissioner ruled in the Turrish case that the \$79,975 representing the excess of the amount received by Turrish over the par value of his shares upon their surrender was income for the year 1914, this ruling was reversed by the district court, the circuit court of appeals (236 Fed. 653) and the Supreme Court. The reversal was not upon the express ground that the Commissioner had erred in taxing "dividends" as gains and profits, resulting from the sale of property, but such a decision was unnecessary in view of the court's more fundamental and sweeping conclusion that the dividends in question were not taxable at all, because they were capital. The Supreme Court did not decide that they were taxable *as ordinary gains or profits.* Such a decision would have been academic, if not inconsistent with its main conclusion. There is absolutely nothing in the Turrish case requiring the taxation of corporate earnings or profits accumulated subsequent to March 1, 1913, as gains and profits from the sale and exchange of property, except a ruling of the Commissioner which was completely set aside by the courts upon the most fundamental ground possible. Effect should be given, if possible, to the entire Revenue Act of 1918, and no part should be permitted to perish by construction. One part should not be allowed to defeat another part if by any reasonable construction the two can stand together (U. S. v. Ninety-Nine Diamonds, 139 Fed 961). The treasury department's construction of subdivision (e) of § 201 seems to be a violation of this cardinal rule of statutory construction. The theory underlying the exemption of dividends from the normal tax is that the normal tax upon them had already been paid by the corporation declaring them. So far as the subject of any corporate distribution may represent earnings or profits accumulated subsequent to February 28, 1913, it has been subjected to the normal tax in the hands of the paying corporation. *So far as the normal tax is concerned*, it is capital, like the undistributed income of estates or trusts upon which the fiduciary has paid the

remaining capital.[39] Where a corporation surrendered its charter on January 31, 1920, its business being thereafter continued as a partnership by the stockholders, and distributed its surplus and undivided profits as of December 31, 1919, as a liquidating dividend, the net income of the company for the one

tax. § 201 (c) seems clearly to be directed at another profitable element involved in a liquidation—the excess of the amount received upon a liquidation over the value of the stock on March 1, 1913 (or its cost if acquired subsequently thereto), *plus the earnings and profits accumulated* subsequently to February 28, 1913. This is a very different gain or profit from the taxable earnings or profits distributed. Moreover, it will be noted that the Revenue Act of 1918 uses the word "any" in § 201 (a) 1. The word has just been carefully qualified by a parenthetical clause—"(except in ¶ (10) of subdivision (a) of § 234)". In view of the familiar meaning of the word "any" and the careful qualification immediately prior to it (which dismisses the possibility that congress intended any further qualifications) in § 201 (a) 1, it becomes essential that § 201 (c) be read not as an exception, but as supplementary to § 201 (a), intended to reach another kind of possible profit than that contemplated in § 201 (a). Again, § 201 (c), as it stands, need not be construed as a qualification of § 201 (a). The phrase "other gains or profits" includes "dividends." (§ 213 (a)). In so far, then, as the gain or profit realized is a dividend it should be taxed as a dividend, that is, it should be subjected only to the surtaxes. Both the Turrish and Hornby cases were decided under the Act of October 3, 1913, which did not contain the definition of the term "dividend" to be found in the Revenue Act of 1916 and the 1918 Law. The Supreme Court admitted that its decision in the Hornby case would have been different had the 1913 Law contained any such definition. Two further rules of statutory interpretation should resolve any doubt remaining on this question. (1) The courts will avoid, if possible, any interpretation resulting in absurdity, inconsistency, glaring inequality or palpable injustice, giving effect to the spirit rather than the letter. (See Ch. 47.) (2) In the interpretation of statutes levying taxes it is also the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. (See Ch. 47.) If the mere fact that a distribution out of a corporation's earnings or profits accumulated since February 28, 1913, is made upon the liquidation of the corporation renders such earnings or profits liable a second time to the normal tax, the manner of distribution supplants the character of income as the decisive test of taxability. If a distribution made by a corporation out of its earnings or profits accumulated since February 28, 1913, is held under the 1918 Law to be a dividend only when made by a going corporation, the burden of the taxpayer is increased,—the taxpayer is subjected to an additional tax of 4 or 8% upon dividends received as a part of a liquidation. The clear import of the language used in § 201 does not require this—to say the least—and any remaining doubt should be resolved against the government and in favor of the citizen. As will be seen by the next paragraph, congress has recognized the injustice of the interpretation of the treasury department of § 201 (c) and provided against its continuance in the 1921 Law.

[39] A. R. M. 93, T. B. 47-20-1309.

month of its existence in 1920 being distributed by crediting the amount to the profit and loss account of the partnership, it was held that such a liquidating dividend credited to the partnership was taxable to the former stockholders as if actually distributed to them.[40]

RETIREMENT OF CAPITAL STOCK. Payments by a corporation to its stockholders in retiring its own stock have been held not to be dividends within the meaning of the 1918 Law if the liquidation was in pursuance of an obligation arising out of the stock contract, unless it appeared that the corporation had an option of distributing its assets with a debit to capital stock account or to surplus account. Any excess received by the stockholders upon such retirement over the cost of the stock was held to be a taxable profit.[41] In a case in which a corporation retired twice the amount of additional stock previously issued in connection with the performance of government contracts during the war, the amount representing the par value of the stock being charged to capital account and an excess over par value paid by the corporation to retire the stock being charged to surplus accumulated prior to March 1, 1913, it was held that the distribution was not a dividend within the meaning of the 1918 Law but was a distribution in part liquidation. Any excess over the cost of the stock was held to be subject to the *normal tax* and the surtax in the hands of the stockholders.[42]

PROCEEDS OF LIQUIDATION RECEIVED IN INSTALLMENTS. Where the assets of a corporation in process of liquidation are being disposed of, the proceeds being distributed to the stockholders in installments, and it is not known what the total proceeds will be, and consequently the amount of profit to the stockholders can not be definitely determined, it was held under the 1918 Law that a stockholder should return no portion of the installment payments as income until the amount actually received exceeded the cost of the stock to him, or its fair market value as at March 1, 1913, if acquired prior to that date. However, if the corporation entered into a contract for the sale of its assets at a stipulated price, the purchaser making payment in installments, the portion of each liquidating payment to the stockholder representing profit was held to be returnable as in-

[40] O. D. 912, T. B. 20-21-1630.

[41] O. D. 360, T. B. 2-20-667. Such profit would probably be held liable to the normal tax as well as the surtax. See Chapter 17 as to the rule if the stock was acquired prior to March 1, 1913.

[42] O. D. 479, T. B. 18-20-891. See also O. D. 488, T. B. 19-20-908.

come for the year during which received.[43] In a case in which a corporation assigned its principal asset (a mortgage payable in annual installments with interest) to trustees in trust for its stockholders and then instituted liquidation proceedings, the beneficiaries under the trust receiving proportionate shares of principal and interest as paid to the trustees, it was held under the 1918 Law that the profit of the stockholders from the surrender of their stock was not definitely ascertainable and that no amount was required to be reported as income until the total sum received in liquidation exceeded the cost of the stock to the stockholders.[44]

PARTIAL LIQUIDATION OF CORPORATIONS. It has been held that where two or more national banks were consolidated,[45] each constituent bank contributing capital, surplus and undivided profits in an aggregate amount less than its existing capital, surplus and undivided profits, the remaining capital, surplus and undivided profits of each constituent bank being liquidated by trustees and the proceeds thereof distributed *pro rata* among the stockholders thereof, so that each stockholder of a constituent corporation received from the consolidated corporation new shares of stock therein upon surrender of his old shares and also received from his trustees his *pro rata* share of the proceeds of the noncontributed assets when liquidated, such stockholder, if he acquired the stock on or after March 1, 1913, was required under the 1918 Law to pay both normal tax and surtax on (1) his share of the proceeds of the liquidated assets in excess of the cost of that portion of his old stock representing the capital assets so liquidated; and (2) any profit derived from the sale of his new stock, such profit to be computed by deducting from the selling price of the new stock the cost of that part of the old stock represented by the new stock which he sold. Any gain accrued prior to March 1, 1913, was held exempt if the old stock was acquired prior to that date.[46]

[43] O. D. 343, T. B. 30-19-635. The first part of this ruling is covered by the provisions of § 202 (c), and the proceeds distributed would go to reduce the basis for ascertaining gain or loss. It is a question whether this would be true of the second part of the ruling—if the price were stipulated—in view of subdivision (f) of § 202. However, it would seem that even if the amount of gain should be calculated with respect to each installment, the taxpayer would not be obliged to report any gain under the present law until the proceeds exceeded the basis.

[44] O. D. 461, T. B. 16-20-874. The same conclusion would seem necessary under the present law.

[45] Under the Act of November 7, 1918 (40 Stat. 1043).

[46] Sol. Op. 115, T. B. 36-21-1797.

Distribution in Liquidation Under 1921 Law. The Revenue Act of 1921 omits the provision as to distributions in liquidation contained in the 1918 Law[47] and provides[48] that any distribution (whether in cash or other property) made by a corporation to its shareholders or members *otherwise than out of (1) earnings or profits accumulated since February 28, 1913*, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the cost, or value as of March 1, 1913, for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee. Under the present law, then, earnings or profits accumulated since February 28, 1913, whether distributed in liquidation or as ordinary dividends, will be taxed as dividends and subject only to the surtaxes and will no longer be taxed as other gains and profits in the case of liquidation as under the 1918 Law. Congress has now definitely provided against the unfair and unwarranted practice of the treasury department under the 1918 Law of subjecting such earnings or profits to both the normal tax and the surtax in case of the mere accident of their distribution in the liquidation of a corporation.

Presumption as to Source of Distribution. In the case of a corporation any distribution (which in the case of a personal service corporation does not include distributions out of earnings or profits accumulated between December 31, 1917, and January 1, 1922) to stockholders is made so far as possible (a) from earnings or profits; (b) during the year 1918 or thereafter from earnings or profits accumulated since February 28, 1913; (c) if during the first 60 days of a taxable year, from earnings or profits accumulated during preceding taxable years; and (d) if during the remainder of a taxable year after the first 60 days, from earnings or profits accumulated during the taxable year up to the date of distribution. The presumption contained in clauses (c) and (d) affects the determination of invested capital for the purpose of the excess-profits tax, which is repealed by the Revenue Act of 1921 as of December 31, 1921, and the provision creating the presumption is expressly made inapplicable after that date. In ascertaining whether or not a distribution was made out of earnings or profits of the taxable year there should first be set aside a proper reserve for the payment of accrued income and war-profits and excess-profits taxes. In the case of

[47] § 201 (c).

[48] Revenue Act of 1921, § 201 (c). See footnote 38.

a personal service corporation any distribution is deemed to have been made so far as possible (a) from earnings or profits; (b) during the year 1918 or thereafter from earnings or profits accumulated since February 28, 1913; (c) if during the first 60 days of a taxable year, from the most recently accumulated earnings or profits of preceding taxable years; and (d) if during the remainder of the taxable year after the first 60 days, from earnings or profits accumulated during the taxable year up to the date of distribution. The first 60 days of any taxable year includes March 1, except during a leap year.[49]

Dividends From Earnings or Profits Accumulated Prior to March 1, 1913. Under the 1918 Law any distribution was deemed to have been made from earnings or profits unless all earnings and profits had first been distributed. Any distribution made in the year 1918 or any year thereafter was deemed to have been made from earnings or profits accumulated since February 28, 1913, but any earnings or profits accumulated prior to March 1, 1913, might be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, had been distributed.[50] With an ex-

[49] Revenue Act of 1921, § 201; Revenue Act of 1918, § 201; Reg. 45, Art 1542. See A. R. R. 577, T. B. 38-21-1824; A. R. R. 127, T. B. 23-20-992; O. D. 5, T. B. 1-19-9; O. D. 4, T. B. 1-19-8. In A. R. R. 127 it is held that the 60-day presumption applies to the determination of invested capital alone, but it would seem to affect the determination of the source of distributions of personal service corporations made between January 1, 1918, and March 1, 1918, and for that reason the text above retains the reference to this presumption in the case of personal service corporations. It will have no effect in the case of distributions by personal service corporations during the first 60 days of 1922, since it is repealed as of December 31, 1921. It is stated in the Finance Committee Report on the Internal Revnue Bill of 1921 (p. 10) in regard to § 201: "Minor obscurities in the present law have been clarified by stating conclusively certain provisions which heretofore have been stated as presumptions." The reference is apparently to the substitution of the word "is" for the words "shall be deemed to have been."

[50] Revenue Act of 1918, § 201 (b). Compare with Revenue Act of 1916, § 31, added by Revenue Act of 1917. (See Reg. 45, Arts. 1542 and 1543.) The conflict in the cases in the lower federal courts under the 1913 Law, as to the taxability of dividends distributed subsequent to the incidence of the tax from earnings which accrued prior thereto (the law itself being silent on that point) was settled by the 1917 provision. In Lynch v. Turrish, 247 U. S. 221, it was held that a sum received by a stockholder in excess of the par value of his stock, exclusively from the increase in value of his stock prior to March 1, 1913, on account of the gradual advance of the value of the property of the corporation prior to that date, was not income when distributed by the corporation after the incidence of the tax. In Lynch v. Hornby, 236 Fed. 661, decided at the same time, the lower court

held that dividends received by a stockholder by the conversion of property into money and the distribution after the incidence of the tax, was not taxable where the dividend represented the value of property owned by the corporation on March 1, 1913, including the increase of the value of its timber lands and *surplus from its business operations*, the court announcing that, in its opinion, no property held by the corporation or the stockholder whether original capital or previously earned surplus income, gains or profits, was intended to be made, or was made taxable as income by the 1913 Law, so far as it represented the value of such property on March 1, 1913. The Supreme Court reversed this decision, 247 U. S. 339, distinguishing the case from the situation in Lynch v. Turrish on the ground that the dividends to Hornby were not single and final, and did not represent the winding up or liquidation of the entire assets and business of the company, and a return to him of the value of his stock upon his surrender of his entire interest, and on the ground that congress drew a distinction between a stockholder's undivided share or interest in the gains and profits of the corporation prior to the declaration of a dividend, and his participation in the dividends declared and paid; the court proceeding on the theory that the stockholder is in the ordinary case a different entity from a corporation and that congress was at liberty to treat dividends coming to him as constituting a part of his income when they came to hand, even though they might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. The court distinctly held that under the 1913 Law dividends declared and paid in the ordinary course by a corporation to its stockholders after March 1, 1913, *whether from current earnings or from a surplus accumulated prior to that date*, were taxable as income to the stockholder. (See Skinner v. Union Pacific Coal Co., 249 Fed. 152.) The case of Peabody v. Eisner, 247 U. S. 347, followed Lynch v. Hornby in principle. In Southern Pacific Co. v. Lowe, 238 Fed. 847, the district court held that dividends from surplus accumulated prior to March 1, 1913, were not taxable if the surplus represented an increase in the value of the assets of the corporation, but were taxable if the surplus was accumulated from earnings or profits of the corporation prior to the incidence of the tax. This decision was reversed by the Supreme Court (247 U. S. 330), but only on the ground that the corporation which paid the dividend and the corporation which received it were in substance identical corporations, the stockholder, therefore, not being the ordinary stockholder contemplated in Lynch v. Hornby. (See also Hays v. Gauley Mountain Coal Co., 247 U. S. 189; U. S. v. Cleveland, etc., Ry. Co., 247 U. S. 195; Doyle v. Mitchell Bros., 247 U. S. 179; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71 and T. D. 2740; Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904; State ex rel. Moon Co. v. Wisconsin Tax Commission, 166 Wis. 287, 163 N. W. 639, 165 N. W. 470, appeal dismissed by U. S. Supreme Court, 249 U. S. 621; Van Dyke v. Milwaukee, (Wis.) 146 N. W. 812, 150 N. W. 509; State ex rel. Pfister v. Widule, (Wis.) 163 N. W. 641; State v. Franklin Bank, 10 Ohio 91; Bailey v. Railroad Co., 22 Wall. 603, 106 U. S. 109; Collector v. Hubbard, 12 Wall. 1.)

ception discussed in a subsequent paragraph[51] the Revenue Act of 1921 carries substantially the same provision with respect to earnings and profits accumulated prior to March 1, 1913. For the purposes of the Revenue Act of 1921 every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee will not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided for ascertaining gain or loss exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon.[52]

RULINGS UNDER 1917 AND 1918 LAWS. Several important rulings were made under the 1918 and previous laws in regard to the exemption of distributions consisting of earnings or profits accumulated prior to March 1, 1913, as indicated below:

1. Stock dividends do not constitute a distribution of earnings and the presumptive allocation as to earnings does not apply to them; hence a dividend paid in cash by a company was deemed to represent a distribution of its earnings or surplus accumulated since February 28, 1913, and remaining undistributed at the date of payment, regardless of the issuance by the corporation of any stock dividends since February 28, 1913, and prior to the date of payment of the cash dividend. Where a corporation, having a surplus accumulated in part prior to March 1, 1913, transferred to its capital account a portion of its surplus, issued new stock representing the amount so transferred to the capital account and then declared a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash was deemed to have been paid out of surplus accumulated since February 28, 1913, to the extent of the earnings and profits accumulated since that date, and was subject to tax, but the portion of the dividend paid in stock was held exempt.[53]

[51] See p. 525.

[52] Revenue Act of 1921, § 201 (b). See Chapter 17.

[53] O. D. 587, T. B. 29-20-1065.

2. In the case of a corporation having had earnings in any year since March 1, 1913, a dividend was deemed to be out of such earnings even though such earnings had been more than offset by subsequent losses so that there had been a net operating deficit since March 1, 1913.[54]

3. In the case of a corporation with profits accumulated prior to March 1, 1913, but none accumulated between that date and January 1, 1918, and paying dividends during the first 60 days of 1918, such dividends were deemed to have been paid from earnings or profits accumulated after December 31, 1917.[55]

4. In a case in which in 1919 a corporation paid three deferred dividends on its outstanding first preferred stock, the dividends being those due February 1 and August 1, 1910, and February 1, 1911, the actual surplus necessary to pay them having accumulated prior to December 31, 1911, it was claimed that the terms of issue of the stock prescribed when the dividends became due, the company merely having the privilege of deferring payment; and that it was the understanding of the company that its surplus was held to pay past due dividends. The stock certificates contained a provision in accordance with which the deferred dividends were paid and the stock redeemed. It was held that the three deferred dividends would be considered to have been paid out of earnings and profits accumulated since February 28, 1913, unless it could be shown that all earnings and profits accumulated since that date were first distributed. If this could not be shown, the distribution was held to constitute income to the recipient stockholders subject to surtax but not to the normal tax.[56]

5. Where the principal stockholder paid in to a corporation a sum of money for which no stock was issued and on which no interest was charged, it being entered upon the company's books as a contribution of capital and never treated as an account payable, the repayment of this sum to the stockholder was deemed to be out of undivided profits or earned surplus so far as possible and not a return of capital, unless the undivided profits

[54] O. D. 610, T. B. 31-20-1098; T. B. R. 43, T. B. 12-19-395. The treasury department construed the phrase "profits accumulated" to mean profits which had been earned and not dissipated by subsequent losses. (A. R. M. 82, T. B. 40-20-1219.)

[55] T. B. R. 43, T. B. 12-19-395. The effect of this ruling was to subordinate subdivision (e) of § 201 to subdivision (b), the former, together with subdivision (d), providing for the *method* and *rate* of taxation and the latter for *liability* to taxation.

[56] O. D. 587, T. B. 29-20-1065.

and earned surplus accumulated since 1913 had been first distributed as dividends.[57]

6. It has been held that a distribution made from the proceeds recovered in 1916 on a claim for unlawful restraint of trade suffered in the years 1891 to 1904, which was in litigation and existed as a chose in action arising *ex delicto* long prior to March 1, 1913, was not from profits accrued after March 1, 1913, and was not taxable under the 1916 Law, in the absence of evidence that the claim was of greater value in 1916 than on March 1, 1913.[58]

Rulings Under the 1916 Law. The 1916 Law, prior to its amendment by the 1917 Law, did not contain any presumptive provision as to the source of corporate distributions. The treasury department ruled that dividends could be declared from any specified fund, that is, a dividend could be declared from surplus accumulated prior to March 1, 1913, and consequently be free from tax in the hands of the stockholders, although the corporation had surplus and undivided profits accumulated since that date sufficient to pay the dividend.[59] The presumption provision contained in the 1917 amendment to the 1916 Law was held not to apply to any distribution made prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913. The treasury department held that if a dividend was declared prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913, such dividend would be deemed to be from the most recently accumulated profits or surplus unless the dividend was also paid prior to August 6, 1917. In other words, the provision in regard to "most recently accumulated earnings or profits" has reference to the earnings or profits in existence at the time of the *payment* of the dividend, and not the time of *declaration*.[60]

[57] T. B. M. 82, T. B. 23-19-552.

[58] Park v. Gilligan, U. S. Dist. Ct., So. Dist. Ohio; I. T. S. 1921, ¶ 3067.

[59] But a stockholder who received payments from a corporation because of his stock ownership therein, which payments were not the result of a formal declaration of dividends and which were not then entered on the books against surplus accrued prior to March 1, 1913, was held taxable with respect to such distribution of corporate profits as dividends. The formal declaration of such dividends by the directors at a date one year after the dividends had been paid and subsequent entries made on the corporate books, did not have the effect of relieving the taxpayer of tax. (O. 932, T. B. 25-19-579.)

[60] Letter from treasury department dated February 9, 1918; I. T. S. 1918, ¶ 3099; telegram from treasury department dated January 31, 1918; I. T. S. 1918, ¶ 3069; telegram from treasury department dated July 5, 1918; I. T. S. 1918, ¶ 3592.

The presumption was held applicable even though profits of the corporation were invested in obligations of the United States issued after September 1, 1917, as the investment of earnings did not prevent them from being distributed as dividends.[61] It was immaterial what disposition had been made of the funds earned in the taxable year;[62] the net income as disclosed by the books as having accrued up to the date on which the dividends were paid was deemed to be distributed thereby.[63] In view of the difficulties which many corporations had in determining whether earnings in 1917 up to the date of dividend payment in that year were sufficient to cover the dividend paid, corporations were permitted to distribute the earnings for the accounting period for which the dividend in question was paid ratably over the period for the purpose of determining the amount of earnings during the period up to the date of payment.[64] In determining the source of earnings from which a particular distribution was made, a corporation was permitted to treat the undivided profits and surplus of the current year as reduced by payments for income and excess-profits taxes, cr if keeping its accounts upon an accrual basis by proper reserves for such taxes, although such payments or reserves were not deductible in computing the income of the corporation for income and excess-profits taxes.[65] In this respect the language of the present law and the 1918 Law is substantially the same as that of the 1916 Law, as amended, and the above rulings still apply.

BOOK ENTRIES. In determining whether a distribution was made out of earnings or profits accumulated after or before March 1, 1913, it was held under the 1918 Law that due consideration must be given to the facts and that mere book entries increasing or decreasing the surplus would not be conclusive.[66] Where original entries on the books and records of a corporation showed that a dividend paid prior to August 6, 1917, represented a distribution of earnings accumulated prior to March 1, 1913, the dividend was held exempt from tax under the 1918 Law even though it was not specifically stated in the resolution

[61] Letter from treasury department dated May 27, 1918; I. T. S. 1921, ¶ 860.

[62] Id.

[63] T. D. 2659.

[64] T. D. 2678.

[65] T. D. 2700; T. D. 2736; Letter from treasury department dated May 13, 1918; I. T. S. 1919, ¶ 808.

[66] Reg. 45, Art. 1543. See Southern Pacific Co. v. Lowe, 247 U. S. 330; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71.

authorizing payment of the dividend that it was to be paid from such earnings.[67] It has been held that a dividend will be deemed to have been paid out of current earnings to the extent possible and taxable to the recipient accordingly, notwithstanding that there was an actual impairment of capital and the books show an apparent surplus based on an arbitrary valuation of good-will, trade-marks, etc.[68]

SUCH DIVIDENDS EXEMPT ONLY TO STOCKHOLDERS OF FIRST CORPORATION. Under the 1916 Law it was held that where dividends had been paid from surplus accrued prior to March 1, 1913, they were free from tax in the hands of the stockholder, but if such stockholder was a corporation, upon the distribution to its stockholders of the sum so received as dividends, the fund became taxable to the stockholders of the second corporation as, to the holding company, such sum did not represent earnings or profits accrued prior to March 1, 1913. While the law provided for the exemption of dividends from corporate funds earned prior to March 1, 1913, it was held it did not provide for tracing the identity or character of such dividends after the receipt thereof by the stockholders of the corporation which earned the fund prior to the incidence of the tax.[69]

DIVIDENDS RECEIVED BY AN ESTATE. Dividends received by an estate are not exempt because paid from surplus accumulated prior to the creation of the estate, but are taxable either to the beneficiaries if the income is distributable, or to the estate if it is not distributable,[70] unless paid from earnings or profits accumulated by the corporation prior to March 1, 1913.

Dividends From Exempt Income. Although interest on state bonds and certain other obligations is not taxable when received

[67] O. D. 655, T. B. 36-20-1180.

[68] O. D. 163, T. B. 6-19-266. This ruling seems to violate the fundamental rule that book entries are only evidential and are not conclusive (See Doyle v. Mitchell, 247 U. S. 179). If the dividend in question was in fact a distribution of capital, it should be free from tax notwithstanding any "apparent" surplus based on arbitrary valuations. This is practically the effect of T. D. 2734 in which it was held (when a stock dividend was considered taxable) that stock dividends created from a revaluation of capital assets or to represent value placed upon trade-marks, good-will, etc., were not taxable to the shareholder.

[69] Letter from treasury department dated July 23, 1917; I. T. S. 1918, ¶ 284. Contra, State ex rel. Moon v. Nygaard (Wis.) 175 N. W. 810, decided under the Wisconsin statute.

[70] Letter from treasury department dated October 19, 1915; I. T. S. 1921, ¶ 665. The principle of the decision in Matter of Osborne, 209 N. Y. 450 was referred to in this letter and held to have no application to the income tax law.

by a corporation, upon amalgamation with the other funds of the corporation such income loses its identity and when distributed to stockholders in dividends is taxable to the same extent as other dividends.[71]

Distribution From Depletion or Depreciation Reserve. A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of its surplus out of which ordinary dividends may be paid. A distribution made from such a reserve will be considered a liquidating dividend. No distribution, however, will be deemed to have been made from such a reserve except to the extent that the amount paid exceeds the surplus and undivided profits of the corporation.[72]

Dividends Paid From an Appreciation of Corporate Assets Prior to March 1, 1913. It was held under the 1918 Law that a profit made by a corporation in 1918 or subsequent years from the realization of appreciation of corporate assets accrued before March 1, 1913, is taxable income to the stockholder when distributed as a dividend in 1918 or subsequent years. In other words, if a corporation purchased capital assets in 1910 for $10,000, which had a value on March 1, 1913, of $20,000, and sold the assets in 1918 for $20,000, the realized gain of $10,000 was held taxable when distributed to the stockholders.[73] The 1921 Law would require a different conclusion, since it expressly provides for the exemption of distributions of "any increase in value of property accrued prior to March 1, 1913."[74]

Dividends Paid From an Appreciation of Corporate Assets Subsequent to March 1, 1913. Any distribution (whether in cash or other property) made by a corporation to its shareholders or

71 Reg. 45, Art. 1541; Reg. 33 Rev., Art. 4.

72 Reg. 45, Art. 1549, as amended by T. D. 3206, T. B. 33-21-1767; O. D. 736, T. B. 48-20-1320. The taxation of liquidating dividends is discussed on p. 517.

73 L. O. 1073, T. B. 43-21-1878. This conclusion was founded upon the cases of Lynch v. Hornby, 247 U. S. 339; Lynch v. Turrish (discussed in footnotes 38 and 50); Gray v. Darlington, 15 Wall. 63; Eisner v. Macomber, 252 U. S. 189; and Merchants Loan & Trust Co. v. Smietanka, 41 Sup. Ct. Rep. 386; T. D. 3173. The distribution was taxable under the Hornby and Turrish cases unless it was a distribution made out of earnings or profits accumulated prior to March 1, 1913. (Revenue Act of 1918, § 201 (b).) Since advance growth or increment in value are not "earnings or profits" within the meaning of the other cases cited above until realized through sale, the above increment in value, which accrued prior to March 1, 1913, was not, therefore, an earning or profit until 1918.

74 Revenue Act of 1921, § 201 (b).

members otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, will be applied against and reduce the basis provided for ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee.[75]

Distributions of Capital. Distributions of capital by corporations do not become income because they are called dividends. The reason why dividends paid out of earnings and profits accumulated prior to March 1, 1913, are free from tax is that such earnings and profits are assumed, for income tax purposes, to have the status of capital. It has been held that a dividend declared and paid by a corporation which was in part illegal because in excess of true earnings, and which dividend was later rescinded by the corporation, was not taxable to the stockholders to the extent that the corporation had a legal right to force rescission and repayment and to the extent that such rescission and repayment were actually made.[76] But where a dividend is legally declared by a corporation, which later is *voluntarily* returned by the stockholders to avoid an impairment of its capital (the corporation in a later year having received an additional assessment of taxes for the year in which the dividends were paid) the amount thereof is subject to tax in the year in which received by the stockholders and, being a contribution to capital, may not be deducted from gross income by the stockholders in the year in which repaid.[77]

Dividends Taxable in Year Received. The mere declaration of a dividend is not a distribution. All dividends are taxable at the rates for the year in which actually or constructively received (that is, "when the cash or other property" forming the subject of distribution is "made unqualifiedly subject to their (the stockholders') demands") regardless of when the earnings and profits out of which they were paid were accumulated.[78] This

[75] Revenue Act of 1921, § 201 (c). Under this provision a distribution of increment in the value of corporate assets accuring after March 1, 1913, might be made free from tax provided the distribution did not exceed cost (or value on March 1, 1913) but for the presumption that distributions are from earnings or profits to the extent thereof. In the absence of earnings or profits accumulated since March 1, 1913, such increment might be distributed without tax to the extent indicated.

[76] T. B. M. 77, T. B. 20-19-502.

[77] Sol. Op. 110, T. B. 25-21-1691.

[78] Reg. 45, Arts. 31 and 1541; Letter from treasury department dated February 18, 1915; I. T. S. 1918, ¶ 271; Revenue Act of 1918, § 201.

is now an express provision of the statute, but the rule had become firmly established prior to the enactment of the Revenue Act of 1921.[79]

In a recent case suit was brought by the stockholders of a corporation in 1917 to compel the corporation to distribute accumulated cash surplus, as a result of which the court ordered the distribution made, with interest from the date of the decree. The corporation took no steps to comply with this order, and no dividend was declared and no amount made available to the stockholders, but the company appealed the case. The judgment of the lower court was not affirmed until February, 1919, at which time the amounts in question were distributed to the stockholders. The treasury department held that no amounts became available to the stockholders as income until the judgment of the lower court was affirmed in 1919.[80] Since the date of payment rather than the date of receipt was the governing factor in determining when a dividend should be treated as taxable income under the 1917 and 1918 Laws a dividend paid in Missouri and received there by stockholders on December 30, 1917, but not received by stockholders in California until January, 1918, was held taxable in the 1917 returns to the California stockholders.[81]

Dividends Paid in Equivalent of Cash. The Revenue Act of 1921 includes in its definition of the term "dividends" any distribution made by a corporation to its shareholders or members "whether in cash or in other property."[82]

Dividends Paid in Property. It is well settled that dividends paid in securities or other property (other than its own stock), in which the earnings of a corporation have been invested, are income to the recipients to the amount of the fair market value of such property when receivable by the stockholders. If such stock is subsequently sold, the difference between its market value at the date of receipt (actual or constructive) and the

[79] Revenue Act of 1921, § 201 (e). This provision may have been prompted by the dictum in Park v. Gilligan, U. S. Dist. Ct., So. Dist. Ohio; I. T. S. 1921, ¶ 3067, to the effect that amounts merely "credited" as dividends and not "actually segregated from the general assets of the company" were not income.

[80] A. R. R. 124, T. B. 25-20-1012. See Revenue Act of 1921, § 201 (e).

[81] O. D. 97, T. B. 2-19-140. Likewise, under the present law such dividends would seem to be subject to the demand of the California stockholders in the earlier year, though they would have difficulty in enforcing the demand.

[82] Revenue Act of 1921, § 201 (a). The Revenue Act of 1918 included stock dividends, but they are no longer taxable (see p. 531).

selling price is additional income or loss, as the case may be. A dividend paid in stock of another corporation is not a stock dividend. Where a corporation declares a dividend payable in stock of another corporation, setting aside the stock to be so distributed and notifying the stockholders of its action, the income arising to the recipients of such stock is its fair market value at the time the dividend becomes payable.[83]

In a recent case the directors of a corporation voted an issue of debenture bonds from the surplus or undivided profits and distributed the bonds to its stockholders. The stockholders contended that the distribution of these debenture bonds was analogous to the payment of a stock dividend and that they should not be subject to tax on the value of the bonds. It was contended that the bonds had the characteristic features of preferred stock and that in case of insolvency or bankruptcy the debenture holders would not rank as general creditors. The court held, however, that the plaintiffs received an actual payment (in the form of securities available for distribution in the market and entirely severed or distinguished from their control of the property as stockholders) of profits which the company wished to distribute as earnings to its stockholders. The distribution to the stockholders of the debenture bonds was a distribution of obligations which, like promissory notes, call for the payment of cash and do not invest the holder with merely a different form of holding of stock. Since, so far as these debenture bonds were concerned the corporation was solvent, there could be no question between the persons receiving these dividends and creditors as to priority of payment and to whatever extent they might be of value this value was separate from any stockholders' control of the corporation. The court held that the stockholders were subject to tax on that portion of the value of the bonds representing surplus earned after March 1, 1913.[84]

Where a national bank utilized a portion of its undivided profits in the creation of a savings bank and trust company, the stock of said savings bank and trust company being issued in the names of trustees for all shareholders of the national bank,

[83] Reg. 45, Art. 1544; Reg. 33 Rev., Art. 4. Letter from treasury department dated November 12, 1918; I. T. S. 1921, ¶ 875; O. D. 471, T. B. 17-20-883; T. D. 3052, T. B. 33-20-1141. In Peabody v. Eisner, 247 U. S. 347, a case arising under the 1913 Law, a distribution in stock of another corporation was held not to be a stock dividend and was held to be taxable even though it partially represented surplus acquired prior to March 1, 1913.

[84] Doerschuck v. U. S., 274 Fed. 739, T. D. 3170, T. B. 24-21-1681. See O. D. 801, T. B. 7-21-1441.

and the certificates of stock of the national bank showing on the face thereof that the holders are entitled to their pro rata share of the capital stock of the savings bank and trust company, the stockholders will be deemed to have received a dividend in specie and will be liable for tax on the value of certificates of stock in the new corporation received by them.[85]

PROPERTY DIVIDEND UPON REORGANIZATION. Where a corporation engaged in the producing, manufacturing and transporting petroleum, and owning and operating a pipe line for the transportation thereof, having a surplus in excess of the value of such pipe line, transfers the pipe line property to a new corporation organized for the purpose, the stock of the new corporation being issued first to the producing corporation and then by it distributed to its stockholders, the Supreme Court has held the stock so received by such stockholders to be a dividend paid in property within the meaning of the 1913 Law. The same conclusion was reached in a case presenting substantially the same facts except that the stock of the new pipe line corporation was transferred directly to the stockholders of the producing corporation.[86]

DIVIDENDS PAID IN LIBERTY BONDS. The fact that dividends are paid in Liberty Bonds does not exempt them from tax. When Liberty Bonds are used as a medium of payment, whether in discharge of a private debt or in payment of a corporate dividend, the profit or gain derived by the recipient is neverthe-

[85] O. D. 152, T. B. 5-19-243.

[86] Rockefeller v. U. S., N. Y. Trust Co. v. Edwards, 42 Sup. Ct. Rep. 68. The court said in these cases: "Looking to the substance of things the difference is unessential. In each case the consideration moved from the oil company in its corporate capacity, the new company's stock issued in exchange for it was distributed among the oil company's stockholders in their individual capacity, and was a substantial fruit of their ownership of stock in the oil company, in effect a dividend out of the accumulated surplus. * * * Nevertheless the new stock represented assets of the oil companies standing in the place of the pipe line properties that before had constituted portions of their surplus assets, and it was capable of division among stockholders as the pipe line properties were not. The distribution, whatever its effect upon the aggregate interests of the mass of stockholders, constituted in the case of each individual a gain in the form of actual exchangeable assets transferred to him from the oil company for his separate use in partial realization of his former indivisible and contingent interest in the corporate surplus. It was in substance and effect, not merely in form, a dividend of profits by the corporation, and individual income to the stockholder." See also U. S. v. Phellis, 42 Sup. Ct. Rep. 63, discussed at length in Chapter 17.

less subject to income tax.[87] The stockholder should make return of the dividend paid in Liberty Bonds on the basis of the cash value of the Liberty Bonds at the time of their receipt by him.[88]

SCRIP DIVIDENDS. Dividends paid in scrip have been held to be equivalent to a payment in cash and an investment of the cash in the scrip and accordingly taxable to the extent of the face value of the scrip. Such dividends are held subject to tax in the year in which the warrants are issued. In the event of a failure to realize the face value of the scrip, it was held under the 1918 Law that a loss might be claimed in the year in which the stockholder parted with the scrip.[89] Where an insurance company issues certificates of profit based upon premiums received on marked off risks of the previous year, such certificates maturing in six years and subject to future losses and expenses until redeemed, interest being payable annually upon their face value, it has been held that such certificates are in the nature of scrip dividends. Inasmuch as they might be affected by gains or losses of the company during their maturing period, the certificates were held not to be income until the taxable year of maturity or redemption. The amount of interest payable annually on the certificates constitutes taxable income for the year in which received.[90]

[87] Letter from treasury department dated June 30, 1917; I. T. S. 1919, ¶ 785; Letter from treasury department dated June 22, 1917; I. T. S. 1921, ¶ 908. The second of these letters is based upon an opinion on the subject obtained from the Attorney General by the treasury department. The question was raised by reason of the language of the act authorizing the first issue of Liberty Bonds (Act of April 24, 1917, Public No. 3) which exempted the principal and income from taxation.

[88] Letter from treasury department dated November 12, 1918; I. T. S. 1921, ¶ 875.

[89] Reg. 45, Art. 1544; O. D. 589, T. B. 29-20-1067; Letter from treasury department dated January 19, 1915; I. T. S. 1918, ¶ 260. Scrip dividends were held taxable under the act of June 30, 1864, Bailey v. Railroad Company, 22 Wall. 603, 106 U. S. 109. It is a question whether scrip dividends redeemable in cash or stock are not to be considered as stock dividends, particularly if upon redemption all stockholders take stock rather than cash. (See U. S. v. Mellon, U. S. Dist. Ct., W. Dist. Pa., I. T. S. 1921, ¶ 3091.) In any event, it is to be doubted whether scrip dividends are properly taxable at their face value in the year in which the warrants are issued. The credit of the corporation paying the dividends and the interest the scrip bears is a material point. The scrip certificates may be readily convertible into cash and in such case the market or discounted value thereof would clearly be income unless the scrip dividend is a stock dividend. But if there is no market for the scrip, it is to be doubted whether it constitutes income until cash or its equivalent is received.

[90] O. D. 589, T. B. 29-20-1067.

Stock Dividends. The 1913 Law was silent as to stock dividends and while the treasury department at first held that such dividends were not subject to tax, it subsequently changed its attitude and held stock dividends to be the equivalent of cash and to constitute taxable income under the same conditions as cash dividends.[91] The 1916 Law expressly provided that stock dividends should be taxable. It defined a stock dividend as a distribution by a corporation out of its earnings or profits accrued since March 1, 1913, and payable to its shareholders in stock of the corporation. It was provided that such stock dividends should be considered income to the amount of the earnings or profits so distributed.[92] The Revenue Act of 1918 also expressly provided that stock dividends should be taxable. It defined a stock dividend as a distribution made by a corporation, other than a personal service corporation, to its shareholders or members in stock of the corporation out of its earnings or profits accumulated since February 28, 1913, or in the case of a personal service corporation any such distribution out of earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[93] The United States Supreme Court reversed the decision of the treasury department as to the 1913 Law and held that stock dividends were not taxable under that law.[94]

Notwithstanding the broad language of the opinion in that case the treasury department declared that since only the language of the 1913 Law and not the language of the 1916 or 1918 Laws was before the court, it did not necessarily follow that stock dividends were not taxable under the provisions of the 1916 and 1918 Laws, and it continued to assess the tax on such dividends.[95] This question has now definitely been set at

[91] T. D. 2274, dated December 22, 1915.

[92] Revenue Act of 1916, § 31 added by Revenue Act of 1917. The 1916 Law prior to the amendment contained substantially the same definition of stock dividends.

[93] Revenue Act of 1918, § 201 (a).

[94] Towne v. Eisner, 245 U. S. 418. It has been held that a corporation stockholder is not taxable under the 1909 Law on stock dividends received. (U. S. v. Philadelphia B. & W. R. Co., 262 Fed. 188.)

[95] See letter to Collectors dated January 10, 1918, I. T. S. 1919, ¶ 811. In the opinion of the treasury department the court did not decide that such dividends could not be income within the meaning of the Sixteenth Amendment, but expressly recognized that the word "income" might have a different meaning in the statute from the meaning in the Constitution.

rest by a case[96] holding that the provision of the 1916 Law by which stock dividends were in terms stated to be income and to be taxable as such to the same extent as cash dividends was unconstitutional. In this case the United States Supreme Court clearly holds that from every point of view, neither under the Sixteenth Amendment nor otherwise, has congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. The present law expressly declares that a stock dividend shall not be subject to tax "but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913.[97]

Definition of Stock Dividend. It is, therefore, important to consider the definition of the term "stock dividend" which is so exempted from tax. The decision above referred to holding that stock dividends are not constitutionally taxable has been declared by the Treasury Department to sustain the following propositions:[98]

1. Where a corporation, being authorized so to do by the laws of the state in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so issued to its stockholders, such stock is not income to the stockholders and the stockholders incur no liability for income tax by reason of its receipt.

2. Where a corporation, being authorized, increases its capital stock, and simultaneously declares a cash dividend equal in amount to the increase in its capital stock, and gives to its stockholders a real option either to keep the money for their own or to reinvest it in the new shares, such dividend is a cash divi-

[96] Eisner v. Macomber, 252 U. S. 189. The procedure on claiming credit or refund of taxes erroneously paid on stock dividends is indicated in the supplement to the 1920 edition of this book, p. 195. See M. 2429 and M. 2436, T. B. 11-20-789 A, 789 B; O. D. 625, T. B. 32-20-1123.

[97] Revenue Act of 1921, § 201 (d). The reference of this provision is to stock dividends, not paid in good faith. In Eisner v. Macomber, the court said: " * * * we are considering the taxability of *bona fide* stock dividends only."

[98] T. D. 3052, T. B. 33-20-1141.

dend and is income to the stockholders whether they reinvest it in the new shares or not.[99]

3. Where a corporation, which is not permitted under the laws of the state in which it is incorporated to issue a stock dividend, increases its capital stock and at the same time declares a cash dividend under an agreement with the stockholders to reinvest the money so received in the new issue of capital stock, such dividend is subject to tax as income to the stockholder.[100]

4. Where a corporation, having a surplus accumulated in part prior to March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will, to the amount of the surplus accumulated since March 1, 1913, be deemed to have been paid out of such surplus, and be subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income.[101]

[99] See also T. B. R. 42, T. B. 12-19-398; O. D. 565, T. B. 27-20-1034; T. B. R. 63, T. B. 22-19-529. But the option must be real. Looking through the form to substance, it has been held that a dividend payable in cash but actually paid in the case of 1740 out of 112,080 shares of stock of the paying corporation, the acceptance of such payment in stock being a matter of agreement by a large proportion of the stockholders as a part of a refinancing arrangement and the paying corporation having in fact no funds to pay the dividends in cash, was a stock dividend within the meaning of the 1913 Law (U. S. v. Mellon, U. S. Dist. Ct., W. Dist. Pa.; I. T. S. 1921, ¶ 3091).

[100] The same reasoning applies to national banks which are authorized by law to issue only cash dividends (see Instructions of the Comptroller of the Currency relative to the organization and powers of national banks for 1919, p. 56). Cash dividends declared by a national bank coupled with the right to apply the same to the purchase of an increase in capital stock are therefore subject to the surtax in the hands of the stockholder. (I. T. S. 1921, ¶ 2514; O. D. 588, T. B. 29-20-1066.) It has been held that where an assessment of income tax has been treated by both parties in the court below as an assessment on a stock dividend and has been so treated in the assessment of tax by the Commissioner, it cannot be upheld in the Circuit Court of Appeals as an assessment on a cash dividend although the corporation's surplus was distributed by check, which was endorsed by the stockholders in exchange for the stock, the assessment having been made on a value of the stock which was more than double the face of the check. The assessment must be made by the Commissioner and cannot be made by the court. (Loomis v. Wattles, 266 Fed. 876.)

[101] See also O. D. 587, T. B. 29-20-1065.

5. Where a corporation increases its capital stock and the stockholders are permitted to purchase the new issue of stock for one-half par, the corporation transferring from surplus to capital one-half the par value of the new shares issued, each stockholder receiving such new stock may treat one-half the stock received as a stock dividend.[102]

6. A stock dividend paid in true preferred stock is exempt from tax the same as though the dividend were paid in common stock, but if the stock issued and distributed as a dividend ranks with or prior to the interest of general creditors (with respect to the payment of either interest or principal), it can not be considered true preferred stock, and must be treated as income to the recipient.[103]

7. A corporation declared a dividend payable in stock of the company at par. In making the distribution of fractions of shares scrip certificates were issued and in order to facilitate the disposal for the stockholders of their scrip, where they did not desire to purchase additional scrip to entitle them to a full share of new stock, the corporation sold in the open market as an agent of the stockholders the scrip certificates received for fractional shares of dividend stock, this sale being entirely optional with the stockholders. It was held that the scrip certificates received as a dividend did not represent a cash dividend but a stock dividend and were not subject to tax.[104]

Income Derived on Sale of Stock Received as Dividend.[105] Stock issued by a corporation as a dividend does not constitute taxable income to a stockholder in such corporation, but gain may be derived or loss sustained by the stockholder from the sale of such stock. The amount of taxable gain derived or deductible loss sustained from the sale of such stock or from the sale of the stock with respect to which it is issued, will be determined in accordance with the rules regarding the basis for determining gain or loss from sales set forth elsewhere in this book,[106] after the cost, or both the cost and fair market value as of March 1, 1913, if acquired prior thereto, of both the old and the new shares is determined in accordance with the following rules:

(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the

[102] A. R. M. 128, T. B. 22-21-1659.

[103] O. D. 801, T. B. 7-21-1441.

[104] O. D. 859, T. B. 14-21-1538.

[105] The rule set forth in this paragraph issued prior to the enactment of the Revenue Act of 1921, would seem to be applicable thereunder.

[106] See Chapter 17.

stock dividend is paid, the cost of each share, and when acquired prior to March 1, 1913, the fair market value as of such date, will be the quotient of the cost, or such fair market value of the old shares of stock, divided by the total number of the old and new shares.[107]

(2) Where the stock issued as a dividend is in whole or in part of a character or preference materially different from the stock upon which the stock dividend is paid, the cost, and when acquired prior to March 1, 1913, the fair market value as of such date, of the old shares of stock should be divided between such old stock and the new stock, in proportion, as nearly as may be, to the respective values of each class of stock, old and new, at the time the new shares of stock are issued, and the cost, and when acquired prior to March 1, 1913, the fair market value as of such date, of each share of stock will be the quotient of the cost or such fair market value as of March 1, 1913, of the class to which such share belongs divided by the number of shares in that class.

(3) Where the stock with respect to which a stock dividend is issued was purchased at different times and at different prices and the identity of the lots can not be determined, any sale of the original stock will be charged to the earliest purchases of such stock, and any sale of dividend stock issued with respect to such stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the dividend chargeable to such stock.[108]

(4) Where the stock with respect to which a stock dividend is declared was purchased at different times and at different prices, and the identity of the lots can or can not be determined, but the dividend stock issued with respect to such stock can not be identified as having been issued with respect to any particular lot of such stock, then any sale of such dividend stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the stock dividend chargeable to such stock.[109]

Where the resolution of the board of directors of a corporation, declaring a stock dividend, provided that no fractional shares of stock should be issued, but that all fractions of shares should be united into whole shares and sold by the treasurer and the proceeds thereof paid to the stockholders entitled thereto, such

[107] This method has been upheld in Towne v. McElligott, U. S. Dist. Ct., So. Dist. of New York, decided August 6, 1921.

[108] Reg. 45, Art. 1547, as amended by T. D. 3206, T. B. 33-21-1767.

[109] Reg. 45, Art. 1547, as amended by T. D. 3238, T. B. 44-21-1901; O. D. 478, T. B. 18-20-890.

resolution having been approved by the stockholders, it was held that the stockholders by approving the action of the board of directors approved and, in fact, authorized the action of the treasurer in uniting and selling the fractional shares and paying over the proceeds therefrom to those stockholders entitled thereto, and that those stockholders entitled to receive fractional shares, but who actually received cash representing their portion of the proceeds of the sale of the fractional shares should compute the gain or loss thereon under the rules stated above.[110] It has been held that stockholders receiving a stock dividend upon stock purchased at different times subsequent to February 28, 1913, and at different prices, may not use as a basis for computing gain or loss upon the sale of such dividend stock, the quotient of the total cost of the purchased stock divided by the total number of old and new shares added together. Each share of dividend stock sold must be allocated to a particular lot of purchased stock and the basis for determining gain or loss upon the sale of any such stock shall be determined by using the cost of the shares to which such dividend share has been allocated. If the particular lots can not be identified, the provisions of (3) above must be followed. If, however, the taxpayer is able to identify his various purchases, he may allocate, according to his wishes, the stock received as a dividend, except that no share of purchased stock may, for the purpose of this computation, be credited with more than its proportionate share of the dividend stock. In computing the gain or loss upon the sale of the purchased stock it is held that the same basis must be used in each case as is used in computing the gain or loss resulting from the sale of dividend stock allocated to the particular lot of purchased stock which is sold.[111]

STOCK DIVIDENDS RESULTING FROM REVALUATION OF ASSETS. When stock received in payment of a dividend resulting from a revaluation of assets or stock in respect of which any such dividend was paid, is sold, the cost of each share of stock, whether old or new, for the purpose of ascertaining the gain or loss resulting from its sale, is the quotient of the cost of the old stock, if acquired on or after March 1, 1913, or its fair market price or value as of that date if acquired prior thereto, divided by the number of old and new shares added together. The profit so ascertained from the sale of such stock is income subject to both normal and surtax in the year in which the sale is made.[112]

110 O. D. 781, T. B. 5-21-1412.
111 O. D. 735, T. B. 48-20-1319.
112 T. D. 2734; S. 1081, T. B. 11-19-368; A. R. R. 6, T. B. 30-19-634.

Taxation of Dividends at Rates in Force in Previous Years. Under the 1916 Law, as amended, the rate of tax on dividends received in 1917 depended upon the year in which the amount distributed as dividends was earned by the paying corporation. The law provided expressly that the dividends should be a part of the annual income of the distributee for the year in which received, but should be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation.[113] This provision was limited to stock dividends under the 1918 Law, and since such dividends were held exempt from tax, the provision has no application under that law.[114] It is also inapplicable under the present law, which taxes all dividends at the rates in force in the year in which they are actually or constructively received.

113 Revenue Act of 1916, § 31, added to by Revenue Act of 1917.
114 Revenue Act of 1918, § 201.

CHAPTER 20

RECEIPTS AND INCOME FROM MISCELLANEOUS SOURCES

After specifying a number of sources of income, the Revenue Act of 1921, like the Revenue Act of 1918, provides that the gross income of the taxpayer shall include gains or profits and income derived from any source whatever.[1] In this chapter are set forth the rulings on income from sources not covered by the preceding chapters and on certain receipts which are not income. The principal change made by the Revenue Act of 1921 discussed in this chapter is the new statutory provision for replacement funds which, it will be noted, differs from the rule heretofore established by departmental practice and is made retroactive. Other less important changes are the partial exemption of dividends on interest from building and loan associations, the exemption of war pensions, and the provision with regard to an employees' profit-sharing fund.

Alimony. Alimony is not income, as it does not arise from any business transaction, and is not founded on any contract, but on the natural and legal duty of the husband to support the wife.[2] An allowance based on a separation agreement is also exempt from tax.[3] It follows that the husband cannot deduct amounts paid as alimony or an allowance paid under a separation agreement from his gross income for the purpose of the tax.[4]

Amount Paid for Option to Purchase Interest in Royalties. An amount paid simply to bind an option to purchase an interest in royalties to be derived from certain patents, which does not affect the ownership of the patents, is income and not a return of the capital invested in the patents.[5]

Amount Received by Tenant as Compensation for Vacating Premises. A sum of money paid to a taxpayer pursuant to an agreement reached upon the termination of a leasehold contract before its expiration, and for the purpose of defraying a personal expense in the nature of storage charges upon the tax-

[1] Revenue Act of 1921, § 213 (a); Revenue Act of 1918, § 213 (a).

[2] Gould v. Gould, 245 U. S. 151. This decision reversed the ruling of the treasury department on the point. It may not be deducted by the husband (see Chapter 20).

[3] Reg. 45, Art. 73.

[4] Reg. 45, Art. 291.

[5] O. D. 1028, T. B. 37-21-1813.

payer's household goods, constitutes an item of gross income within the meaning of the statute.[6]

Cancelled Debts. The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect.[7] It may amount to a payment of income or to a gift or to a capital transaction. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation.[8] Transactions involving the rendering of returns in consideration of the cancellation of an indebtedness are treated elsewhere in this book.[9]

Involuntary Sale. In general, profits actually realized through the sale of property are not exempt because the sale was involuntary. An involuntary sale constitutes a closed and completed transaction for the purpose of determining gain or loss,[10] unless the taxpayer proceeds to establish a replacement fund.[11] Where property owned by an estate was in 1906 listed by a city to be condemned for public purposes, but was not destroyed until 1917, during which year a verdict was rendered awarding the estate an amount, with interest at the rate of 6% per annum from 1906, mandamus proceedings being instituted to enforce the settlement of this award, and in 1920 the estate received payment of the face value of the claim, together with interest accrued since 1906, and costs, it has been held that as the taxpayer had a claim on March 1, 1913, for the payment of this amount with interest accrued to that date, the measure of taxable income is the difference between the fair market value of the claim for the principal and interest on March 1, 1913, and the sum actually received representing such principal and accrued interest. The cost of mandamus proceedings was a replacement of the amount expended by the estate in the collection of a due debt and should not be included in the gross income of the estate. However, the cost of such mandamus

[6] A. R. R. 617, T. B. 37-21-1812.

[7] Reg. 45, Art. 51. See Great Northern Ry. Co. v. Lynch, T. D. 3147, T. B. 13-21-1532, in which it was held under the 1909 Law that unpaid obligations written off the books because of the running of the statute of limitations constituted income in the year written off.

[8] U. S. v. Oregon-Washington, etc. Co., 251 Fed. 211.

[9] See Chapter 15.

[10] A. R. R. 1, T. B. 25-19-587.

[11] See paragraph "Replacement Fund for Loss."

proceedings can not be taken as a deduction in computing net income of the estate for the year in which expended.[12] The requisition of property by the government in 1917 for war uses and payment therefor of a price named by the commission of the war department is considered a sale or other disposition of property.[13]

Compensation for Loss. In the case of property which has been lost or destroyed in whole or in part through fire, storm, shipwreck, or other casualty, or where the owner of property has lost or transferred title by reason of the exercise of the power of requisition or eminent domain, including cases where a voluntary transfer or conveyance is induced by reason of the fact that a technical requisition or condemnation proceeding is imminent,[14] that amount received by the owner as compensation for the property which is in excess of the cost of the property constitutes gain. However, the gain which is taxable in the case where the property was acquired before March 1, 1913, and its fair market value as of that date was greater than its cost, is the excess over such value of the amount received. No taxable gain results when the amount received is more than the cost, but less than the fair market value of the property as of March 1, 1913. In any case proper provision must be made for depreciation to the date of the loss, damage, or transfer. The transaction is not regarded as completed at this stage, however, if the taxpayer proceeds immediately in good faith to replace the property, or if he makes application to establish a replacement fund as provided in the following paragraph. In such a case, under the regulations issued under the 1918 Law, the gain, if any, was measured by the excess of the amount received over the amount actually and reasonably expended to replace or restore the property substantially in kind, exclusive of any expenditures for additions or betterments. The new or restored property effects a replacement in kind only to the extent that it serves the same purpose as the property which it replaces without added capacity or other element of additional value. Such new or restored property may not be valued in the accounts of the taxpayer at an amount in excess of the cost, or its value as of March 1, 1913, if acquired before that date and such value as of such date is higher than the cost (after making proper provision in either case for depreciation to the date of the loss,

[12] O. D. 591, T. B. 29-20-1071.

[13] O. D. 897, T. B. 18-21-1604. See p. 543, however, as to establishing a replacement fund in such cases.

[14] See A. R. M. 101, T. B. 50-20-1341.

damage or transfer), of the original property, plus the cost of any actual additions and betterments. If the taxpayer does not elect to replace or restore the property, the transaction will then be deemed to be completed and the gain will be the difference between the cost of the property and the amount of the compensation received. If such property was acquired prior to March 1, 1913, and its fair market value as of that date was greater than such cost, the taxable gain will be the excess over such fair market value of the amount of the compensation received. However, no gain will be taxable when the amount received is more than the cost of such property, but less than its fair market value as of March 1, 1913. In any event proper provision must be made for depreciation to the date of the loss, damage, or transfer. This ruling has no application to property which is voluntarily sold or disposed of.[15] It applies to residential and farming property.[16]

Compensation for Loss Under 1921 Law. The above ruling was not made under any specific provision of the 1918 Law, but there has been embodied in the Revenue Act of 1921 the following provision: If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (a) its destruction in whole or in part, (b) theft or seizure, or (c) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The Act provides that this provision prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, apply "so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax acts."[17] It will

15 Reg. 45, Art. 49, as amended by T. D. 3206, T. B. 33-21-1767.

16 O. D. 513, T. B. 21-20-949.

17 Revenue Act of 1921, §§ 214 (a) 12 and 234 (a) 14. See also Revenue Act of 1921, § 202 (d) 2.

be seen that the provision of the 1921 Law changes the basis for determining gain or loss from such transactions. Under the regulations promulgated under the 1918 Law, the cost of the property was disregarded and the gain was the excess of the amount received for the property over the amount expended in the replacement thereof. Under the present law the gain or loss is first computed by taking the difference between cost and the amount received for the property. From the gain (if any), a deduction may be taken of that portion of such gain which the portion of the amount expended in replacement bears to the entire amount received. Thus, under the 1918 Law, if a taxpayer received $100,000 for his property and replaced it by an expenditure of $80,000, his taxable gain was $20,000, irrespective of the cost of the property. Under the present law, if the property cost $70,000, $100,000 was received for it and $80,000 was spent in replacing it, the gain would be $30,000, but there may be deducted from such gain 4/5 thereof, leaving a taxable gain of $6,000. This new provision may, in some cases, provide much greater relief than was formerly granted and it would seem that taxpayers will be allowed to recompute such gains and if they are reduced by the application of the new method may be allowed a credit or refund of any excess taxes previously paid.

In addition, the 1921 Law permits taxpayers, instead of actually replacing the lost or converted property, to take advantage of the above provision by acquiring 80% or more of the stock or shares of a corporation owning such property similar or related in service or use to the property converted.

RULINGS UNDER 1918 LAW. The following rulings were made under the 1918 Law, upon the subject discussed in the previous paragraphs:

(1) An amount in excess of recovery for loss expended for replacement of an asset "in kind" is not deductible as a loss when the entire fund so recovered is equal to or greater than the book value of the asset. Thus, where the cost of the asset is $5,000, the replacement cost $5,000 and the recovery $4,000, there is a deductible loss of $1,000, but where the cost of the asset is $5,000, the replacement cost $11,000, and the recovery $10,000 the taxpayer may not deduct $1,000 (the difference between the replacement cost and the amount of recovery) as a loss. This excess is to be treated as a capital expenditure which is recoverable through depreciation deductions.[18]

[18] A. R. M. 122, T. B. 18-21-1607.

(2) Where a taxpayer elects to replace a vessel by one somewhat larger, so long as the general type of the boat is the same as the boat lost or destroyed, it may fairly be taken as a replacement in kind, insofar as it equals the tonnage of the original vessel. There should be charged against the replacement fund only such portion of the cost of the new vessel as would represent the cost of a boat of the carrying capacity of the old vessel, with allowance for depreciation.[19]

(3) Where the government, having requisitioned vessels from a taxpayer for use in the war, returns the same vessels in an unfit condition for their former use, giving the taxpayer a sum of money in lieu of restoration, the vessels are deemed to be substantially different property from that taken from the taxpayer, and the taxpayer may elect to sell the vessels returned and place the proceeds, together with the money paid in lieu of restoration, in a replacement fund.[20]

(4) Where the owner of a requisitioned tug uses the proceeds to buy barges, he does not replace in kind within the meaning of the above rulings.[21]

(5) The purchase of a steamship from a subsidiary, from the replacement fund of another subsidiary, can not be considered a replacement in view of the provisions of the income-tax law governing the taxation of affiliated corporations.[22]

Replacement Fund for Loss. The 1921 Law gives the Commissioner, with the approval of the secretary, authority to make regulations respecting the use of replacement funds.[23] The following regulation was issued under the 1918 Law:

In any case in which the taxpayer elects to replace or restore the lost, damaged or transferred property, but where it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which the entire amount of the compensation so received shall be held without deduction for the payment of any mortgage, and pending the disposition thereof the accounting for gain or loss thereupon may be deferred for a reasonable period of time, to be determined by the Commissioner.[24] In such a case the taxpayer

[19] T. B. M. 61, T. B. 15-19-443.

[20] T. B. R. 41, T. B. 12-19-400.

[21] O. 914, T. B. 20-19-504.

[22] A. R. M. 142, T. B. 48-21-1942. See Chapter 10.

[23] Revenue Act of 1921, §§ 214 (a) 12 and 234 (a) 14.

[24] The period during which the replacement fund may be maintained may properly be limited to one year with the privilege of the taxpayer to apply at the end thereof for a further extension (T. B. M. 61, T. B. 15-19-443).

should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund and in his application should recite all the facts relating to the transaction, including the nature of the property, the character and extent of the loss, the manner and date of securing compensation, the date of acquisition of the property and its cost or fair value on March 1, 1913, the amount of compensation, the amount necessary to make the damage good, a description of the replacement intended and the steps already taken to that end, the probable date of compensation, the estimated additional excess-profits and income taxes assessable upon the income carried to the replacement fund, and all other matters which might affect a determination. He must undertake that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require for an amount not less than the estimated additional income and war-profits and excess-profits taxes assessable by the United States upon the income so carried to the replacement fund. The estimated additional taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the secretary of the treasury as acceptable sureties on federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant and the surety or depositary may each have a copy. This ruling has no application to property which is voluntarily sold or disposed of.[25]

Damages in Personal Actions. Damages in the form of yearly payments throughout the life of the injured party, recovered through the compromise of a threatened suit for breach of promise of marriage, are not regarded as a return of capital since the benefits of which the injured party was deprived were merely anticipatory. Such payments are within the statutory

[25] Reg. 45, Art. 50; see Form 1114. Prior to the promulgation of this regulation, the taxpayer, at his option, might, in lieu of furnishing a bond as above indicated, deposit as security for the estimated additional amount of tax, obligations of the United States issued after September 1, 1917, such obligations to be held in trust in a bank or trust company approved by the Commissioner (T. D. 2706). See Revenue Act of 1921, § 1329 as to deposit of Liberty bonds in lieu of sureties.

definition of income and are taxable to the recipient.[26] The alienation of a wife's affections is not such a personal injury as to entitle the recipient of damages therefor to exemption as to such damages. However, so far as such damages represent compensation for sickness resulting from the alienation, they are exempt.[27] Money recovered as damages, in libel proceedings is subject to tax.[28]

Embezzled Moneys. It has been held that moneys embezzled are not such income as the law intended to tax.[29]

Income from Employees' Profit-Sharing Fund. Where the members of a firm establish an employees' profit-sharing fund by transferring a given sum of money to certain employees in trust, such fund being invested in the business of the firm and the interest paid annually to a certain class of employees, who hold certificates entitling them to participate in the profits of the fund, such certificates being subject to cancellation at the pleasure of the firm, the income from the fund was held, under the 1918 Law, to be taxable as a part of the firm's income.[30] Under the Revenue Act of 1921, amounts distributed to employees from such funds are taxable to the distributees to the extent of the excess of the amounts received over amounts paid in by such employees.[31]

Excess of Salvage Value of Discarded or Destroyed Property Plus Depreciation Allowances Over Cost. When property is discarded and salvaged, the depreciation allowance plus the salvage value may slightly exceed or fall slightly below the cost of the property. In the case of a gain over cost this must be treated as income. If the depreciation allowance plus salvage falls below the cost, the difference may be treated as a loss. The fact that a taxpayer in past years neglected to allow for sufficient depreciation does not make the resulting discrepancy between the book values of equipment and its salvage value at the time it is retired from service deductible as a loss. In such cases the taxpayer may avail himself of a larger deduction for deprecia-

[26] O. D. 501, T. B. 20-20-931.

[27] S. 1384, T. B. 24-20-997. Though the alienation of a wife's affections is a personal injury (Leicester v. Hoadley, 66 Kans. 113, 71 Pac. 318; Tinker v. Colwell, 193 U. S. 473, 487), the term "personal injuries" in § 213 (b) 6 is held to mean physical injuries only.

[28] S. 957, T. B. 1-19-21.

[29] Rau v. U. S., 260 Fed. 131, 136.

[30] S. 1329, T. B. 9-20-766.

[31] Revenue Act of 1921, § 219 (f).

tion by submitting amended returns for previous years, and showing that the previous depreciation rate was not reasonable.[32]

Income of Independent Contractor from State Contract. Any profit received from a state or political subdivision thereof by an independent contractor is taxable income. Where warrants are issued by a city, town or other political subdivision of a state, and are accepted by the contractor in payment for public work done, the face value of such warrants must be returned as income. If, for any reason, the contractor upon conversion of the warrants into cash does not receive and can not recover the full face value of the warrants so returned, he may allowably deduct from gross income for the year in which the warrants are converted into cash any loss sustained.[33]

Increment to Sinking Funds. Where a sinking fund is set aside for the purpose of meeting obligations at a future date, all increment to that fund as a result of investments is income to the creator of the fund. Where a sinking fund, controlled by trustees, has been invested in the bonds of the corporation which created the fund, and the corporation pays the trustees interest on such bonds, the amount thereof may be deducted as if paid to any other bondholders, but the same amount must be included as income to the corporation from the sinking fund.[34]

Labor Union Benefits. Benefits paid by a labor union to members during a strike constitute taxable income.[35]

Legacies. A legacy is a gift and the value thereof is not considered income to the recipient, but all income from the legacy is taxable. Unless clearly inconsistent with the intention of the testator, a legacy is held to be vested rather than contingent, and where there is a vested interest the income therefrom, whether distributed or not, is subject to the tax from the time of death of the testator, as income of the legatee.[36]

Payment of Claims. In the case of an estate which on March 1, 1913, owned a claim against some individual or business or government organization, the difference between the amount received in payment of the claim and the actual value of the claim March 1, 1913, is either gain or loss, as the case may be, to be reported in the return for the year in which the claim

[32] S. 1217, T. B. 30-19-639. This decision appears to have been based upon the 1913 Law.

[33] Reg. 45, Art. 37; Reg. 33 Rev., Art. 108.

[34] T. D. 2161.

[35] O. D. 552, T. B. 25-20-1011.

[36] T. D. 2090.

was settled. Interest accrued on the claim from March 1, 1913, to date of settlement is taxable income to the estate. If payment was received in securities which can be proved to have been worth less than face value, the amount to be reported as taxable income is reduced accordingly. If the securities are sold, taxable income will be realized or a deductible loss sustained to the extent of the difference between the amount received from the sale and the actual value of the securities at the time acquired.[37]

Payments Received Through Mistake. If a taxpayer receives, through mistake, an amount in payment of a contract in excess of the amount agreed upon in the contract, the excess is not taxable income. It is in the nature of a liability to the party with whom the contract was made.[38]

Pensions. Pensions and retiring allowances paid by the United States government are subject to the income tax,[39] as also are pensions paid by any other government, or by any private interest, under any contract express or implied. If, however, a so-called "pension" is a mere gratuity or gift it is not taxable as income to the recipient. When one enters the service of an employer who has inaugurated a pension system, such system is one of the inducements for entering the employment, and in such circumstances the fact that the pension is part of the compensation received, and not a gift, is very clear. Even when the pension is granted after the employment has been commenced and without any compulsion, legal or moral, of the employer, it may still fairly be regarded as additional compensation. When the pensions are awarded by one to whom no services have been rendered and who has received no direct benefit from the services rendered, they can not be regarded as additional compensation.[40] Thus, pensions paid by the United States government to widows of soldiers, as such, were held under the 1918 Law not to be taxable income for the reason that such pensions are not awarded as compensation for services rendered to the United States government by the widows and are mere gifts or gratuities.[41] The Revenue Act of 1918 expressly provides that pensions from the United States for service of the beneficiary or another in the military or naval

[37] O. D. 6, T. B. 1-19-11.

[38] O. D. 14, T. B. 1-19-26.

[39] Reg. 45, Art. 32; T. D. 2090.

[40] O. 1040, T. B. 28-20-1051.

[41] O. D. 957, T. B. 26-21-1701.

forces of the United States in time of war are exempt.[42] Where an insurance company entered into a contract with one of its employees agreeing in the event of the death of the latter to pay to his widow for a period of five years all renewal premiums on business originated by him it has been held that such premiums constitute taxable income to the widow.[43]

There is no essential difference in the payments to teachers and the widows of teachers by the Carnegie Foundation for the advancement of teaching from those made to indigent persons by ordinary charitable societies, and they are, therefore, mere gifts or gratuities. The fact that they take the form of pensions and are within the dictionary definition of the term "pension" does not take them out of the definition of the term "gift." The terms "pension" and "gift" are not mutually exclusive. The same payments may be both pensions and gifts.[44]

Property Acquired by Gift. The value of property acquired by gift, bequest, devise or descent (but not the income from such property) is exempt. Such property need not be reported as income by the recipient.[45] Money and real or personal property received as gifts, or received under a will or under statutes of descent and distribution, are exempt from tax, although the income therefrom derived from investment, sale or otherwise is not.[46] The question whether or not a given transaction constitutes a *bona fide* gift, so as to make the income from the property transferred taxable to the donee rather than to the donor, will depend upon the intention of the parties.[47]

The following have been held to be gifts: (1) An amount of principal paid under a marriage settlement. (2) Christmas presents, gratuities, voluntary contributions and donations. An exception, however, is made in the case of clergymen.[48] (3) Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services,[49] including the salary of an employe

[42] Revenue Act of 1921, § 213 (b) (9).

[43] A. R. M. 115, T. B. 11-21-1505.

[44] O. 1040, T. B. 28-20-1051, overruling T. B. 2-20-670. See In re Strong 1 Tax Cas. 207; Blakeston v. Cooper, 5 Tax Cas. 347; Turner v. Cuxson, 2 Tax Cas. 422; Turton v. Cooper, 5 Tax Cas. 148.

[45] Revenue Act of 1921, §§ 213 (b) and 233; Revenue Act of 1918, §§ 213 (b) and 233.

[46] Reg. 45, Art. 73.

[47] A. R. R. 367, T. B. 4-21-1405.

[48] See Chapter 15.

[49] Reg. 45, Art. 107. For a discussion of so-called gifts which are in fact payment for services see Chapter 22.

paid for a limited period after his death to a relative or dependent, in recognition of the services rendered by the employee, no services being rendered by the recipient.[50] (4) An amount returned by an employee to a corporation as part of his compensation previously received under a valid contract.[51] (5) Installments paid to beneficiaries under an endowment policy taken out by another, but any dividends included in such installments will be taxable to the beneficiaries.[52] (6) Personal transportation passes issued by a railroad company to its employees and their families, to be used when not engaged on business for the company, and which are not provided for in the contracts of employment.[53]

Of course, any amount paid by one person out of his income to another, as a gift, is not deductible from the gross income of the giver.[54] An owner of non-tax-free Liberty bonds who has made an absolute gift of the coupons attached to the bonds covering interest due for a number of years will be required to include in his return the interest which accrues each year on the bonds, and to pay any tax that may be due thereon.[55] Where an executor receives a bequest conditioned upon his continuous performance of duties as executor, such a bequest will be deemed compensation for his services, although it is expressly additional to the executors' legal commissions.[56]

Rights to Subscribe to Stock. The Treasury Department has held that where a stockholder acquires the right to subscribe to new stock of the corporation and sells that right the amount received is income.[57] If he exercises the right, it was held that

[50] T. D. 2090; Reg. 33, Art. 6; O. D. 1017, T. B. 36-21-1798.

[51] O. D. 1073, T. B. 43-21-1882.

[52] O. D. 1108, T. B. 47-21-1931.

[53] O. D. 946, T. B. 24-21-1685.

[54] See O. D. 912, T. B. 20-19-505.

[55] O. D. 120, T. B. 3-19-181.

[56] O. 980, T. B. 4-20-700. This ruling is based upon the theory that the bequest is, in effect, additional compensation for services as executor. The law taxes compensation for personal services "in whatever form paid" (Revenue Act of 1921, § 213; Revenue Act of 1918, § 213). Notwithstanding this comprehensive clause, the ruling seems a doubtful interpretation of a statute which expressly exempts bequests. (See Bullen v. Wisconsin, 240 U. S. 625.)

[57] Reg. 45, Art. 39, as amended by T. D. 3206, T. B. 33-21-1767; T. B. M. 73, T. B. 19-19-495; Letter from treasury department dated February 27, 1915, I. T. S. 1918, ¶ 420. In Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904, in which the court held that gains derived from a sale of rights to subscribe for new shares of stock were taxable as income under the Massachusetts Income Tax Law, the court said in part: "Such rights are themselves a species of intangible property. They come to the stockholder as a gratuity. They are a new thing of value which he did not possess before.

no income accrues until the stock subscribed for is sold. In a recent case[58] decided by a district court, this principle laid down by the treasury department has been considerably modified. In this case the court held that the decision of the Massachusetts court[59] upon which the ruling of the department was based was no longer persuasive since the decision of the Supreme Court, holding[60] that stock dividends are not income. In this case the taxpayer acquired 35 shares of stock at $710 per share. The capital stock of the company was doubled and the taxpayer was given the right to subscribe to 35 more shares for $150 per share, and sold his rights for $358.48 per share. The court held that the entire amount derived from the sale of such rights was not income. The court said in part: "The plaintiff in the right of every share it held and which had cost it $710, could, by paying $150 a share more, get another, so that it would have two, which in the aggregate would have cost it $860 or $430 apiece. There would be no way of distinguishing between the old and the new. If the latter was something which had not before existed almost the same might be truthfully said of the former. Its characteristics had undergone a great change. Before the issue of the new stock, it represented one twenty-thousandth of the capital of the company; afterwards it stood for but only forty-thousandths. Moreover, if the plaintiff had, in person, taken the new stock, and had had its old and new consolidated into one certificate, and had subsequently sold a part of its holdings, it could not say that that with which it parted was out of the old or out of the new, or partly out of both. In determining its cost for the calculation of the profit or loss upon resale, it would be necessary to assume that they had one and all cost the holder an equal amount, which in the case of the plaintiff here was $430 a share." In selling the rights, a part of the consideration was that the buyer should assume the payment of the $150 per share so that the taxpayer really

The amount for which he sells them is a gain. * * * They are not regarded ordinarily as a profit from the prosecution of the business, but are an inherent and constituent part of the shares. * * * Their sale resulted from an exercise of judgment to that effect on the part of the stockholder. They are indistinguishable in principle from a sale of the stock itself, and gains derived from sales of such rights fall within the same class of income. The statute in this regard is not in conflict with the amendment."

[58] Safe Deposit & Trust Co. of Baltimore v. Miles, U. S. Dist. Ct., Dist. of Md., decided May 26, 1921; I. T. S. 1921, ¶ 3033.

[59] Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904.

[60] See Chapter 19.

received \$150+\$358.48, or \$508.48 for each share. The gain made on each share on the transaction was, therefore, the difference (\$78.48) between the amount so received (\$508.48) and the cost of each share (\$430). Thirty-five shares were still held by the taxpayer and when they are sold the profit on each share will be the amount by which the selling price per share exceeds \$430.

Sale of Good-Will. Where a corporation sells its assets, including good-will, to a competing corporation, one condition to the sale being an agreement by the president of the vendor corporation not to engage in similar business, for which he is paid a money consideration, the amount so received by the president does not represent a conversion of capital, but is income for the year of its receipt.[61]

Sale of War-Savings Stamps. Income received by an individual or corporation due to selling war-savings stamps at the appreciated value should be reported as income for the year in which the sales were consummated.[62]

Shares in Building and Loan Association. The 1921 Law contains a new provision which exempts so much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed \$300.[63] In general, an amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. Where the amount of such accumulation does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.[64] If a building and loan association subscription was made prior to March 1, 1913, and the share subscribed for had a cash surrender value on March 1, 1913, and any year thereafter in excess of the amount paid in by the shareholder, the determination of any profit realized at the time of cash surrender or for the year of the maturity of the share will be

[61] O. D. 668, T. B. 39-20-1210; L. O. 1045, T. B. 41-20-1231; A. R. R. 250, T. B. 34-20-1157.

[62] O. D. 21, T. B. 1-19-33.

[63] Revenue Act of 1921, § 213 (b) (10).

[64] Reg. 45, Art. 54; Letter from treasury department dated February 8, 1917; I. T. S. 1919, ¶ 949.

based on the proceeds in excess of the cash surrender value as of March 1, 1913, plus the aggregate amount paid in subsequent thereto.[65]

Taxes on Profits from Sale of Property Paid by Vendee. In a case where the vendee of a business agrees that in addition to the purchase price he will pay the income and excess-profits taxes of the vendor arising from the sale of such business, it has been ruled that such taxes paid by the vendee constitute additional taxable income to the vendor.[66]

Tax Paid by Debtor on Account of Tax-Free Covenant Bond. Under the 1918 Law, it was held that where a debtor corporation, in pursuance of a tax-free covenant clause in its bonds paid the 2% normal tax, the amount of the tax paid by the corporation was income to the bondholder. The obligor, in pursuance of a contract voluntarily entered into guaranteed to pay a direct liability of the taxpayer which consisted in paying a certain amount of normal tax for him to the government. The reduction of the payment of his tax liability under such a contract was held to constitute income to him by reducing his expenditures in that amount. The fact that the amount of the liability was paid direct to the government instead of to the taxpayer, did not preclude such an amount from constituting income to the taxpayer.[67] The Revenue Act of 1921, however, expressly provides that the amount of such taxes shall not be included in the gross income of the obligee.[68]

Compensation by Insurance. Insurance money is clearly a substitute for the assets lost or destroyed. If the insurance money is in excess of the cost of the property it may be used to restore the property or be placed in a fund for that purpose for a reasonable time until restoration can be made, final accounting for tax on the excess over the amount actually and reasonably expended to replace or restore the property substantially in kind, being deferred until the restoration or replacement has taken place. If the taxpayer does not elect to restore the property the transaction will then be deemed to be completed. The rulings applicable in either alternative have been given in the earlier part of this chapter.[69] Where a company had a fire in its plant

65 O. D. 446, T. B. 15-20-842.

66 Telegram from treasury department dated May 2, 1919; I. T. S. 1921, ¶ 907.

67 Letter from treasury department dated September 13, 1919; I. T. S. 1921, ¶ 904.

68 Revenue Act of 1921, § 234 (a) (3).

69 See p. 540.

which necessitated shutting down for a day and recovered an amount under a use and occupancy policy of insurance for the loss of use of its factory it is held that sums recovered under such a policy are nothing more than compensation for the loss of anticipated profits, and whether such sums are less than, equal to, or in excess of such anticipated profits for the period of nonuse, they nevertheless represent income.[70]

Proceeds of Life Insurance. The proceeds of life insurance policies paid upon the death of the insured were exempt from tax under the Revenue Act of 1918 if paid to individual beneficiaries, directly or in trust, or to the estate of the insured, but not if to a corporation beneficiary.[71] Under the present law, the proceeds of such policies are exempt irrespective of who the beneficiary may be.[72] If the proceeds are paid in installments under the terms of the policy none of the installments is subject to tax, but, it appears, if the proceeds are paid in installments by agreement between the beneficiary and the insurance company the installments may be free from tax until they aggregate the amount of insurance payable on the death of the insured, and any amount in excess of that sum, due to deferring the payments, is income. Where an individual is the beneficiary it seemed to be immaterial, under the 1918 Law,

[70] O. D. 697, T. B. 43-20-1258. See paragraph "Recoveries on Losses," p. 658.

[71] Revenue Act of 1918, §§ 213 (b) and 233 (a). Reg. 45, Art. 72. The 1916 Law provided that the proceeds of life insurance policies were exempt only when paid to an individual beneficiary upon the death of the insured, and not when paid to the estate of the insured. The senate introduced a provision in the 1918 Law to exempt the proceeds of life insurance policies regardless of to whom they were paid but the Conference Committee limited the exemption to proceeds paid only to individual beneficiaries or to the estate of the insured. In the vast majority of cases the difference between such proceeds and the premiums paid on the insurance represents the loss to a corporation in disturbance of its organization or impairment of good-will occasioned by the death of the officer or employee insured. The proceeds of the policy over and above premiums paid in represents compensation for such loss and is in no true sense income. It is true that the exemption of such proceeds might render possible the evasion of the tax by the over-capitalization of the value of the insured's life and activities to the corporation, in which case, owing to the perpetuity of a corporation's existence, the policy would be an *investment*, perhaps similar to an endowment policy taken out by an individual. This mere possibility of tax evasion, however, does not justify the imposition of a hardship upon the well-run enterprise by the taxation *as profit* of what is essentially *compensation* for a definite and substantial loss. The force of this criticism has been recognized by the 1921 Law, as indicated above.

[72] Revenue Act of 1921, § 213 (b) (1).

whether or not the premiums were paid by the insured or by the beneficiary, since the law granted an absolute exemption with respect to the proceeds of the policy; under the present law it would also seem immaterial, even if the beneficiary were a corporation. In the case of a corporation beneficiary of insurance taken out on the lives of officers or of employees the proceeds, less the total of any premiums paid thereon (and not deducted from net income in the year in which paid, as was permitted prior to the year 1917), was held to be income under the 1918 Law.[73] Such proceeds are entirely exempt under the present law. Since June 25, 1918, no assessment of any federal tax may be made on any allotments, family allowances, compensation or death or disability insurance payable under the War Risk Insurance Act of September 2, 1914, as amended, even though the benefit accrued before that date.[74] The 1921 Law specifically exempts such income.[75] This applies also to dividends on life insurance policies issued by the bureau of war risk insurance.[76]

Amounts received under the terms of an ordinary life, continuous installment bond contract issued by a life insurance company are exempt. This applies not only to the installment payments received, but also to any dividends received under the terms of the bond.[77] Where under a life insurance policy there is payable to a first beneficiary named 6% per annum of the face value of the policy during life, and, upon the death of the first beneficiary, the face value of the policy is payable to a second beneficiary, the payments to the first beneficiary are a part of the proceeds of the policy, and are not to be included in gross income.[78] If a beneficiary has the option of receiving insurance proceeds upon the death of the insured or of leaving the money with the company to draw interest, and the latter course is adopted, it has been held that the beneficiary in effect loans the money to the company and the interest so received is taxable income in the year of receipt. If there is no such option, the rule is otherwise.[79]

TONTINE INSURANCE. When a taxpayer takes out an insurance policy on the tontine plan in 1902 and in 1917 receives the

[73] Letter from treasury department dated March 15, 1918; I. T. S. 1918, ¶ 3290; Reg. 45, Art. 541.

[74] Reg. 45, Art. 72.

[75] Revenue Act of 1921, § 213 (b) (9).

[76] O. D. 1037, T. B. 38-21-1827.

[77] O. D. 433, T. B. 14-20-825.

[78] O. 995, T. B. 10-20-778.

[79] O. D. 612, T. B. 31-20-1101.

total accumulated dividends, the face value of the policy being payable to assured in 1922, if living, the amount received in 1917 is not income for that year. The excess of the amount received at maturity of the policy plus all dividends received thereon, over the total premiums paid prior to March 1, 1913, or the cash surrender value of the policy as of that date, whichever is greater, plus the premiums paid subsequent to March 1, 1913, will represent taxable income to be reported for the year in which received.[80]

DIVIDENDS ON LIFE INSURANCE POLICIES. Dividends paid on life insurance policies that have not matured, whether or not such dividends are drawn in cash by the insured or applied to the reduction of the annual premium due, are not considered items of taxable income. Distributions on paid-up policies which are made out of earnings of the insurance company subject to tax are in the nature of corporate dividends and are income of an individual only for the purpose of the surtax. The former represents merely a return of a part of the premium theretofore paid by the insured, while the latter represent a distribution of income earned by the insurance companies on the premiums paid by the insured.[81]

SURRENDER VALUE OF INSURANCE POLICIES. When an insured person discontinues insurance prior to the maturity of his policy, he is entitled to a certain surrender value which is paid to him by the insurance company. The amount so received represents the return to the insured of a part of the premiums he has paid in the past, and is therefore not income. If the amount should exceed the aggregate of premiums paid, the excess would be taxable income.[82]

ENDOWMENT POLICIES. Where an endowment policy is paid to the insured, it is exempt from tax to the extent that the payment represents a return without interest to the insured of amounts paid by him from time to time as premiums, but is taxable on the excess.[83] Thus, if over a period of years the insured has paid $700 in premiums, and, at the expiration of the terms receives $1,000 from the insurance company, $300 of that sum is taxable income, but the $700, representing return of premiums, is not income.

[80] O. D. 490, T. B. 19-20-910.

[81] Reg. 45, Art. 47; T. D. 2137.

[82] Revenue Act of 1921, § 213 (b) (2); Revenue Act of 1918, § 213 (b) 2; Reg. 45, Arts. 47 and 72; T. D. 2090; T. D. 2152; Letter from treasury department dated February 8, 1917; I. T. S. 1921, ¶ 1197.

[83] Revenue Act of 1921, § 213 (b) (2); Revenue Act of 1918, § 213 (b) 2; Reg. 45, Arts. 47 and 72; T. D. 2090; T. D. 2152.

ACCIDENT, HEALTH OR WORKMEN'S COMPENSATION INSURANCE. Amounts received through accident or health insurance or under workmen's compensation acts as compensation for personal injuries or sickness are exempt, whether the insured be alive or dead and whether received by him, his estate or other beneficiaries.[84] The amount of any damages received by the individual injured or sick, if living, or his estate or other beneficiaries entitled to receive such damages, if dead, whether by suit or agreement, on account of such injuries or sickness is also exempt.[85]

Annuities. The Revenue Act of 1921, like the 1918 Law, provides that the amount received by the insured as a return of premiums paid by him under life insurance, endowment or annuity contracts either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract is exempt from taxation.[86] Under this provision of law the treasury department has ruled as follows: Annuities paid by religious, charitable and educational corporations under an annuity contract are subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds any amounts paid by him as consideration for the contract. An annuity charged upon devised land is income taxable to the annuitant, whether paid by the devisee out of the rents of the land or from other sources. The devisee is not required to return as taxable income the amount of rent paid to the annuitant, and he is not entitled to deduct from his taxable income any sums paid to the annuitant. Where an insured receives under

[84] Revenue Act of 1921, § 213 (b) (6); Revenue Act of 1918, § 213 (b) (6); Reg. 45, Art. 72. Accident insurance was first considered income (to the extent that it exceeded the aggregate premiums paid) but amounts received from a railroad company, by way of reimbursement for expenses incident to an accident were not income. These rulings were revoked, and it was held in pursuance of an opinion of the Attorney General (based upon Doyle v. Mitchell Brothers, 247 U. S. 179, affirming 235 Fed. 686; Lynch v. Turrish, 247 U. S. 221; and Southern Pac. Co. v. Lowe, 247 U. S. 330) that the proceeds of accident insurance policies received by an individual on account of injuries sustained by him through accident were not income under the 1916 Law as amended. (T. D. 2747.)

[85] Revenue Act of 1921, § 213 (b) (6); Revenue Act of 1918, § 213 (b) (6); Reg. 45, Art. 72. Under the 1916 Law amounts received as the result of a suit or compromise for "pain and suffering" were at first held to be income. (T. D. 2135.) This ruling was subsequently revoked. (T. D. 2747.)

[86] Revenue Act of 1921, § 213 (b) (2); Revenue Act of 1918, § 213 (b) (2).

life insurance, endowment or annuity contracts, sums in excess of the premiums paid therefor, such excess is income for the year of its receipt.[87]

[87] Reg. 45, Art. 47; O. D. 612, T. B. 7-19-289. Under the 1913 Law it was held that the amount by which the sum received exceeded the sum paid and coming into the hands of the person making the contracts and payment was income. It was also first held that "when the settlement under such contract and payment is made in more than one payment each payment will be considered as being composed of interest and a proportionate part of the principal," and "where the entire annuity is composed of an interest return upon the principal sum paid therefor, the entire annuity is income." (T. D. 2090.) The matter quoted, however, was afterward stricken out of the ruling. (T. D. 2152.)

CHAPTER 21

DEDUCTIONS—IN GENERAL

Certain deductions are specified in the law for computing the net income of an individual or a corporation.[1] Both the Revenue Act of 1918 and the present law also expressly provide that certain items shall not be deductible in the case of both individuals and corporations.[2] While the deductions allowed corporations and individuals are based upon the same principles, they vary in some particulars, because of differences in the status of these two classes of taxpayers. Thus, an individual may deduct charitable contributions or gifts made within the taxable year, while no corresponding deduction is allowed to corporations. The separate provisions made in the case of individuals for the deduction of losses sustained in any transaction entered into for profit though not connected with trade or business, and losses of property not connected with trade or business, if arising from fires, storms, etc., have no counterparts in regard to corporations, since a corporation's transactions are all entered into for profit and are connected with its business. All losses of a corporation may therefore be deducted, unless they are incurred in *ultra vires* transactions. Certain special deductions are allowed in the case of insurance companies which are not necessary in the case of individuals, and other kinds of corporations.[3] Dividends from domestic corporations and from certain foreign corporations are allowed as a deduction to corporations and to individuals only as a credit for the purpose of the normal tax. The general effect of the Revenue Act of 1918 as compared with preceding laws was to place individuals and corporations more nearly upon the same footing in regard to deductions, and this policy is continued in the present law. In the case of nonresident aliens and foreign corporations the deductions are intended in general to be limited to expenses, losses, etc., paid or incurred in the creation of income taxed by this government.[4] The special provisions applicable to individuals, corporations, nonresident aliens and foreign corporations are set forth in the chapters dealing respectively with those subjects. The general provisions and

[1] Revenue Act of 1921, §§ 214, 234; Revenue Act of 1918 §§ 214, 234.

[2] Revenue Act of 1921, §§ 215, 235; Revenue Act of 1918, §§ 215, 235.

[3] See Chapter 11.

[4] See Chapters 4 and 12. See A. R. M. 100, T. B. 49-20-1331.

principles applicable to all taxpayers are discussed in this and the following chapters. The main amendments made by the Revenue Act of 1921 discussed in this chapter are the changes made in respect to charitable contributions and the provision in regard to the shrinkage in the value of a life or terminable interest acquired by gift, bequest or inheritance.

Only the Deductions Specified in the Statute Are Allowed. Although the tax is imposed on the "net income" of a taxpayer, yet the term "net income" is used as defined in the statute, and not as known generally in accounting practice. Some deductions dictated by prudence and good business management are not recognized or countenanced by the law. Only those deductions which are expressly specified in the statute may be taken for income tax purposes. It may be observed that the present law, to a greater degree than any preceding law, follows the lines of commercial usage in defining net income.[5]

Deductions Must Be Actual. The deductions specified in the statute can be deducted by the taxpayer only when they represent actual payments or actual liabilities. It is not permissible, for instance, for a taxpayer owning the property used and occupied for his or its own business purposes to include as a deduction the rental value of the property so owned. Neither is it permissible to deduct an amount representing the interest which might be earned on the capital employed in the business, if such capital were invested or employed otherwise, or were so placed as to earn a given rate of interest.[6] The deductions claimed must ordinarily be those represented by actual cash disbursements unless the taxpayer keeps his books on some other basis than that of actual receipts and disbursements.

Deductions Not to Be Duplicated. Where a deduction may, or should be, claimed as one of the items specifically stated in the law, such deduction should not also be included under another head. Thus, where a deduction is claimed as depreciation or as a loss, the same amount should not also be deducted as a business expense, or if the cost of tools or small articles has been charged to expense, depreciation should not be claimed thereon, as this would be claiming the same deduction twice. Interest paid by a corporation constitutes a separate deduction and should not be taken into account as a part of the cost of manufacture.[7]

[5] One notable variation even in the present law as construed by the Treasury department is the treatment of corporate organization expenses.

[6] T. D. 2137. Hays v. Gauley Mountain Coal Co., 247 U. S. 189; Walsh v. Brewster.

[7] See Revenue Act of 1921, § 247 (c); T. D. 2137.

Income and Deductions Reported on Same Basis. Net income means gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. The surtax is imposed upon net income; the normal tax upon net income less credits. Though taxable net income is wholly a statutory conception it follows, subject to certain modifications as to exemptions and as to some of the deductions, the lines of commercial usage. Subject to these modifications statutory "net income" is commercial "net income."[8] Deductions are to be reported when the amounts claimed therefor are "paid or incurred" or "paid or accrued" on the books of the taxpayer; that is, when they are actually paid or become a fixed liability according to the method of accounting employed by the taxpayer. In other words, net income is computed on the basis of actual receipts, or on the basis of accrued receipts. Deductions must be claimed on the same basis as that upon which gross income is reported. They must usually be claimed for the year in which the income with the production of which they are connected is reported. The taxable year as a unit of time applies to both gross income and deductions.

Deductions in the Equivalent of Cash. It is not always necessary that an amount claimed as a deduction be paid out in cash. Just as income may be received in kind or in the equivalent of cash, so deductions may be represented by payments in some form other than actual cash. For instance, it has been held that commissions allowed salesmen and paid in stock may be deducted as expense, if so charged on the books of the corporation, at the actual value of such stock.[9]

When Charges Deductible. Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities or deficits of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid

[8] Reg. 45, Art. 21.
[9] T. D. 2625; T. D. 2433; Reg. 33 Rev., Art. 126; Reg. 33, Art. 47.

in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he might, under the 1918 Law, render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return.[10] But under the present law losses may be deducted as of a taxable period different from that in which they were sustained if, in the opinion of the Commissioner, they should be deducted as of such a different period.[11] A more detailed discussion of when deductions should be taken will be found elsewhere in this book.[12]

Contributions to Charities. A citizen or resident is allowed to deduct from his net income contributions or gifts made within the taxable year to or for the use of: (a) The United States, any state, territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (b) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the Women's Auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (c) the special fund for vocational rehabilitation authorized by the Vocational Rehabilitation Act.[13] The 1918 Law expressly permitted the deduction of gifts or contributions when made to corporations or associations organized and operated exclusively for religious, charitable, scientific or educational purposes, or to societies for the prevention of cruelty to children or animals, or to the vocational rehabilitation fund.[14] The above specification of posts of the American Legion or the Women's

[10] Reg. 45, Art. 111.

[11] Revenue Act of 1921, § 214 (a) 6; 234 (a) 4.

[12] See Chapter 33.

[13] Revenue Act of 1921, § 214 (a) 11.

[14] Revenue Act of 1918, § 214 (a) 4.

Auxiliary units thereof, was not made in the 1918 Law, nor did that law include "literary" organizations. Aside from the vocational rehabilitation fund the 1918 Law in terms limited this deduction to corporations (which included "associations") but a gift to a common agency (as a war chest) for several such corporations or associations was held to be the same as a gift directly to them.[15] The 1918 Law did not expressly permit the deduction of gifts "for public purposes" as indicated under (a) above, but such gifts may have been deductible under certain circumstances as indicated below. Like the 1918 Law the present law limits the deduction for gifts or contributions to an amount which in all the above cases combined does not exceed 15% of the taxpayer's net income as computed without the benefit of the deduction. In case of a nonresident alien individual this deduction is allowable only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States, or to such vocational rehabilitation fund. Such contributions or gifts are allowable only if verified under rules and regulations prescribed by the Commissioner, with the approval of the secretary.[16]

The character of the organization receiving a gift rather than the purpose to which the gift is put is ordinarily the test of deductibility.[17] In connection with a claim for this deduction the following information was required to be stated on returns of income and will undoubtedly be required to be so stated under the present law: (a) The name and address of each organization to which a gift was made. (b) The approximate date and amount of the gift in each case. Donations made by a partnership may be prorated among the individual partners for the purpose of their individual returns.[18] This deduction is not allowed to corporations.[19] The deduction discussed in this paragraph does not apply to gifts by estates and trusts.[20]

Contributions in Equivalent of Cash. Where a gift is other than money the basis for calculation of the amount of the

15 Reg. 45, Art. 251.

16 Revenue Act of 1921, § 214 (a) 11.

17 O. D. 465, T. B. 16-20-863.

18 Letter from Treasury Department dated May 23, 1918; I. T. S. 1921, ¶ 553.

19 Thus, Red Cross contributions are not deductible by corporations (T. D. 2847; Telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3436). Contributions are allowed to corporations, however, in some cases when they have consideration in some form so as to take them out of the class of gratuities. See Chapters 10 and 22.

20 See Chapter 6.

gift is the cost of the property, if acquired after February 28, 1913, or its fair market value as of March 1, 1913, if acquired prior thereto, after deducting from such cost or value the amount, if any, which has been or which should have been set aside and deducted in the current year and previous years from gross income on account of depreciation, and which has not been paid out in making good the depreciation sustained.[21]

EXAMPLES OF DEDUCTIBLE CONTRIBUTIONS. Contributions of the following character have been held to be deductible under this provision of the 1918 statute, subject to the 15% limitation:

1. Pew rents and assessments and dues paid to churches;[22]
2. Contributions to a board of education of a school district which has been created a body corporate by the laws of a state;[23]
3. Contributions to a fund established for the pensioning of members of a municipal police force, where such fund is in control of a committee constituted by law;[24]
4. Premiums on a life insurance policy when the beneficiary is an exempt charitable corporation, provided the beneficiary can not be changed at the option of the insured;[25]
5. Contributions for the support of an association organized and operated exclusively for the purpose of giving musical concerts, the programs being of an educational character, and no part of the net earnings inuring to the benefit of any private stockholder or individual;[26]
6. Contributions to the Council of National Defense;[27]
7. Contributions to an association incorporated under the laws of Porto Rico for the purpose of soliciting and obtaining donations to be used in reconstruction work and for charitable purposes in portions of Porto Rico devastated by earthquake and tidal wave;[28]
8. Contributions to an association the object of which is to erect a monumental building as a museum and depositary for records, flags, trophies, etc., of the late war, such museum being

[21] T. D. 2998, superseding T. D. 2966 and T. D. 2977; T. B. 15-20-856. See O. 979, T. B. 7-20-740. Under an earlier ruling the fair market value of the gift at the time the gift is made was the basis for the deduction (Letter from treasury department dated August 14, 1919; I. T. S. 1919. ¶ 3550.)

[22] A. R. M. 2, T. B. 26-19-590.

[23] S. 1052, T. B. 8-19-321.

[24] S. 1202, T. B. 27-19-602.

[25] O. D. 299, T. B. 24-19-566.

[26] S. 1176, T. B. 23-19-546.

[27] S. 992, T. B. 3-19-191.

[28] O. D. 345, T. B. 30-19-641.

held to be of an educational nature, even though the provisions of its charter authorized it to construct, equip, operate and maintain other memorials in the nature of statues, monuments, memorials, assembly halls, memorial halls, music halls, memorial art galleries, or any other building or thing to commemorate persons, causes, occasions, events or principles.[29] A contribution of money towards the cost of an article presented by the contributors to a corporation organized exclusively for educational purposes is deductible from the gross income of the donors within the 15% limitation.

Examples of Nondeductible Contributions. Contributions of the following character were held not deductible under the 1918 Law:

1. Contributions to the National Dry Federation;[30]

2. Contributions made for the purpose of purchasing land and improving same for use as a public park or recreation ground, which is to be dedicated as a memorial to soldiers and sailors who served in the late war;[31]

3. Contributions by citizens of a city for the purpose of inducing an industrial plant to locate in their city;[32]

4. The value of property given to a public high school for athletic purposes;[33]

5. Contributions to a family cemetery corporation organized under the laws of New York;[34]

6. Contributions or gifts made to a corporation organized and operated exclusively for the purpose of erecting and maintaining monuments or other like memorials are not allowable deductions in computing net income of individuals contributing thereto, even though no part of the net earnings of such corporation inures to the benefit of any private stockholder or individual, such corporations not being charitable or educational institutions within the meaning of the Revenue Act of 1918;[35]

7. Contributions to an association engaged in disseminating propaganda to encourage the passage of labor legislation, since such an association is not an educational association;[36]

[29] A. R. R. 301, T. B. 45-20-1294, reversing O. D. 649, T. B. 35-20-1170.

[30] O. D. 44, T. B. 1-19-61.

[31] O. D. 104, T. B. 2-19-152.

[32] O. D. 39, T. B. 1-19-56.

[33] O. D. 126, T. B. 3-19-192.

[34] O. D. 217, T. B. 11-19-379.

[35] S. 1246, T. B. 8-20-755. See Molly Varnum Chapter, D. A. R., v. City of Lowell, 204 Mass. 487, 90 N. E. 893.

[36] S. 1362, T. B. 22-20-971.

8. Contributions to a trust company (a corporation) in trust to invest and disburse them for charitable purposes, the corporation to which the gift is made not being organized and operated exclusively for charitable purposes.[37] "Contributions or gifts" are construed to mean gifts of money or property. The value of services rendered to charitable institutions may not be deducted;[38]

9. A gift of real estate to a city to be maintained perpetually as a public park;[39]

10. Contributions to a memorial fund of which a corporation is trustee and which is controlled by a Board of Directors and organized not to engage in a charitable undertaking itself, but to distribute its income to charitable institutions and to worthy individuals;[40]

11. Contributions made to a "Citizens Club", an unincorporated association which derives its income from annual membership fees, rental of its auditorium and music hall, amounts collected from its dining room, pool tables, bowling alleys, etc., the club never having been self-supporting and the deficit of each year being made up by contributions, the club furnishing to its members facilities for which they pay approximately one-fifth of the cost, where the primary objects sought to be obtained by the organization and operation of the club are the "civic, social and moral betterment of its members and the promotion of every enterprise that concerns the well-being of the community", the "promotion of educational and cultural activities which shall provide such information and facts as will better enable its constituency to form accurate and unbiased judgment of public questions", and also the promotion of athletic and recreational activities.[41]

Items Not Deductible. Certain items are expressly declared not to be deductible in computing net income, as indicated in the following paragraphs:

Personal, Living or Family Expenses. In computing net income no deduction is allowed in respect of personal, living or family expenses.[42] These expenses may be said to be covered by the arbitrary sum allowed as a personal exemption.

[37] O. D. 669, T. B. 39-20-1211. The Revenue Act of 1918 makes no provision for the deduction of charitable contributions to a trust.

[38] O. D. 712, T. B. 44-20-1277.

[39] Reg. 45, Art. 251. See also Reg. 33 Rev., Art. 8.

[40] O. D. 872, T. B. 15-21-1563.

[41] A. R. R. 379, T. B. 6-21-1435.

[42] Revenue Act of 1921, § 215 (a); Revenue Act of 1918, § 215 (a).

The following items have been held to be personal, living or family expenses and as such are not deductible:

(1) Alimony and an allowance paid under a separation agreement; amounts paid as damages for breach of promise to marry;[43]

(2) Insurance paid on a dwelling owned and occupied by a taxpayer including premiums paid on insurance taken out under the War Risk Insurance Act, whether or not subsequently converted; or insurance premiums paid by a wife on the life of her husband when she is the beneficiary of the insurance;[44]

(3) Amounts expended in defending a suit for damages alleged to have been caused by the negligent operation of an automobile owned and operated for personal convenience;[45]

(4) Rent paid for property used for residential purposes;[46]

(5) Amounts expended for purchasing furnishings and maintaining the residential portion of an embassy; the entertainment expenses of ambassadors;[47]

(6) Expenses incurred by doctors in taking post-graduate courses;[48]

(7) Expenses incurred by school teachers in attending summer schools;[49]

(8) Expenses incurred by a railroad conductor in the purchase of uniforms which he is required to wear during business hours;[50]

[43] Reg. 45, Art. 291; O. D. 546, T. B. 24-20-1003; O. D. 275, T. B. 20-19-507. In a case in which a trust fund was created by a divorced husband to continue during the life of his former wife as a guaranty of payment to her of a stipulated amount in lieu of alimony, any income in excess of the stipulated amount to be paid to him and the principal to revert to him upon her death, the Treasury Department first held that the principal of the trust is a part of the estate of the husband, that he is the real beneficiary of the trust, and that the entire income from the trust fund must be included in his return. (O. D. 399, T. B. 6-20-730) but this decision has been overruled (O. D. 1092, T. B. 45-21-1910.)

[44] Reg. 45, Art. 291; O. D. 828, T. B. 9-21-1481; O. D. 48, T. B. 1-19-65.

[45] A. R. R. 444, T. B. 12-21-1527.

[46] Reg. 45, Art. 241. In the case of a professional man who uses a part of his house for his office, such portion of the rent as is properly attributable to such office is deductible, but if such house is used only incidentally for receiving clients, patients or callers, no part of the rent is deductible.

[47] O. D. 1020, T. B. 36-21-1802.

[48] O. D. 984, T. B. 31-21-1755.

[49] O. D. 892, T. B. 17-21-1595.

[50] O. D. 951, T. B. 25-21-1692.

(9) The cost of equipment of an army officer to the extent that it is specifically required by his profession and takes the place of an article required in civilian life;[51]

(10) Payments for the medical services of a throat specialist made by a professional singer;[52]

(11) The attorney's fees paid by a taxpayer engaged in the retail drug business in connection with the prosecution for the illegal sale of narcotics;[53]

(12) Provisions withdrawn by a taxpayer who is the sole proprietor of a business for personal or family use;[54]

(13) Expenditures for the safekeeping of securities and rental of safe deposit boxes;[55]

(14) Allowances made to minor children whether said to be in consideration of services or otherwise;[56] and

(15) Campaign expenses of a congressman.[57]

TRAVELING EXPENSES UNDER THE 1921 LAW. Traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business are made expressly deductible by the Revenue Act of 1921.[58] This provision takes effect as of January 1, 1921, and is a much needed reversal of the impracticable regulations issued under the 1918 Law in regard to traveling expenses.

TRAVELING EXPENSES UNDER PREVIOUS LAWS. Under the 1916, 1917 and 1918 Laws[59] traveling expenses, as ordinarily understood, included railroad fares and meals and lodging. If the trip was undertaken for other than business purposes, such railroad fares were held to be personal expenses and such meals and lodging were living expenses. If the trip was on business, the reasonable and necessary traveling expenses, including railroad fares, and meals and lodging in an amount in excess of any expenditures ordinarily required for such purposes when at home, became business instead of personal expenses. If, then, an individual whose business required him to travel received a salary

[51] Reg. 45, Art. 291. Accordingly, the cost of a sword is deductible, but the cost of a uniform is not.

[52] O. D. 1032, T. B. 37-21-1819.

[53] O. D. 952, T. B. 25-21-1693.

[54] O. D. 998, T. B. 34-21-1777.

[55] Telegram from Treasury Department dated March 8, 1921; I. T. S. 1921, ¶2837.

[56] Reg. 45, Art. 291. The same rule was followed under the Civil War income tax laws (7 Int. Rev. Rec. 60.)

[57] O. D. 864, T. B. 14-21-1549.

[58] Revenue Act of 1921, § 214 (a) 1.

[59] See O. D. 1015, T. B. 34-21-1795.

as full compensation for his services, without reimbursement for traveling expenses, or was employed on a commission basis with no expense allowance, his expenses for railroad fares, and expenses for meals and lodging in an amount in excess of any expenditures ordinarily required for such purposes when at home, were deductible from gross income. If an individual received a salary and was also repaid his actual traveling expenses, he was required to include in gross income an amount thereof equal to the ordinary expenditures required for meals and lodging when at home, as such amount was held to be additional compensation to the taxpayer. If an individual received a salary and also an allowance for meals and lodgings, as, for example, a *per diem* allowance in lieu of subsistence, any excess of the cost of such meals and lodging over the allowance (plus the ordinary expenditures required for such purposes when at home) was deductible, but any excess of the allowance over such expenses (minus such ordinary expenditures) was taxable income. Congressmen and others who received a mileage allowance for railroad fares were required to return as income any excess of such allowance over their actual expenses for such fares. A payment for the use of a sample room at a hotel for the display of goods was a business expense. This contemplated that only such expenses as were reasonable and necessary in the conduct of the business and directly attributable to it might be deducted. A taxpayer claiming the benefit of the deductions referred to herein was required to attach to his return a statement showing (1) the nature of the business in which engaged; (2) number of days away from home during the calendar year on account of business; (3) number of members in taxpayer's family dependent upon him for support; (4) average monthly expense incident to meals and lodging for entire family, including taxpayer himself when at home; (5) average monthly expense incident to meals and lodging when at home if taxpayer had no family; (6) total amount of expenses incident to meals and lodging while absent from home on business during taxable year; (7) total amount of excess expenditures incident to meals and lodging while traveling on business and claimed as a deduction; (8) total amount of other expenses incident to travel and claimed as a deduction. Claims for the deductions referred to herein were required to be substantiated, when required by the Commissioner, by records showing in detail the amount and nature of the expenses incurred.[60] The "home"

[60] Reg. 45, Art. 292, as amended by T. D. 3101, T. B. 51-20-1360. See also In re Assessment of Taxes of T. A. Hayes, 16 Haw. 796; Galm v. U. S., 39 Ct. Cls. 55; A. R. R. 572, T. B. 29-21-1735; O. D. 893, T. B. 17-21-1596;

contemplated by the above ruling is the home maintained for the purpose of carrying on business and not the distant parental home of the taxpayer.[61] The cost of transportation paid by a salaried employee living at a distance from his employment, in order to go to and return from such employment, has been held not to be deductible. This ruling referred to commuters' fares.[62]

Where a taxpayer makes a contract of employment with an employer in this country, and upon completion of such contract he makes a second contract with another employer in a foreign country, without allowance for traveling expenses, the expenditure incurred in reaching such place of employment was not regarded as an expense incurred in furtherance of a trade or business, under the 1918 Law, but rather as an expenditure to fulfill a condition precedent to such employment in a trade or business. The test was held to be whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure.[63]

Amounts expended by a secretary to a member of congress and by his assistants for railroad fares, in making trips from their homes to Washington and return in connection with their duties, might be claimed as a deduction in computing net income under the 1918 Law.[64]

O. D. 924, T. B. 21-21-1650; O. D. 905, T. B. 19-21-1621; A. R. R. 266, T. B. 41-20-1230; O. D. 864, T. B. 14-21-1549. Prior to the promulgation of the above regulations and rulings the regulations of the department contemplated that if an individual undertook a trip on business only his railroad fares and other incidental expenses attributed to business and not expenses for meals and lodging were deductible, on the theory that expenses for meals and lodgings were living expenses. It was then recognized that a certain amount expended while on such a trip might be attributed solely to the business, but the fact that wherever a person may be, at home or abroad, he necessarily must have personal and living expenses, which are not deductible, was not disregarded. In examples (a), (b) and (c) above, this principle was kept in mind and each class referred to was put on the same basis as to such expenses (M. 2688, T. B. 2-21-1389, containing examples showing the applicability of the above ruling.)

[61] O. D. 1021, T. B. 36-21-1803.

[62] S. 1048, T. B. 8-19-317. This conforms to the British practice (See Cook v. Knott, 2 Gt. Br. Tax Cas. 246; Revell v. Directors, 3 Gr. Br. Tax Cas. 12). Its validity may be doubtful. The present law does not seem to contemplate the deduction of such expenses as "traveling expenses," since they are hardly paid while the taxpayer is away from home, in the sense of the statute.

[63] O. D. 451, T. B. 15-20-848. Under the present law it would probably also be held that this expense was not "in pursuit of a trade or business."

[64] O. D. 865, T. B. 14-21-1550.

Improvements and Betterments. Like the 1918 Law the Revenue Act of 1921 provides expressly in the case of individuals and corporations that no deduction shall be allowed in respect of any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property or estate.[65] Amounts expended for additions and betterments add to the value of the property and are considered as a capital investment.[66] If expenditures are made for permanent improvements and betterments they are treated as any other investment of capital; that is, if the asset in which the capital is invested is one on which depreciation may be claimed, the amount expended for the permanent addition or betterment is added to the cost of the property for the purpose of determining the annual depreciation allowance thereafter. The statute merely intends to prohibit the deduction of the entire amount in the year in which the expenditure is made. In a case in which in 1915 the airshaft of a company's mine caved in, causing the destruction of a fan, boiler and drum, and the company did not charge off the loss in 1915 because it had no net income during that year, but restored the equipment in 1917, it has been held that such cost is not merely a replacement chargeable to expense, but is a capital expenditure and consequently not deductible.[67]

Examples of Capital Expenditures. The following have been held to be investments of capital and not deductible business expenses:

(1) Amounts expended for securing copyright and plates which remain the property of the person making the payments;[68]

(2) The cost of defending title or perfecting title to, or reducing an assessment for a local benefit against, property;[69]

(3) Amounts expended for architect's services;[70]

[65] Revenue Act of 1921, §§ 215 (b) 235; Revenue Act of 1918, §§ 215 (b) 235.

[66] Reg. 33, Art. 118. Interest and taxes paid by a corporation in connection with the construction of its original plant are deductible from its gross income under the Revenue Act of 1913, even though such payments are properly chargeable to capital account and are so charged by the corporation on its books, provided the corporation amends its returns so as to exclude the interest and taxes so deducted from capital account. (S. 935, T. B. 1-19-50.)

[67] A. R. R. 97, T. B. 19-20-920.

[68] Reg. 45, Art. 293.

[69] Reg. 45, Art. 293; O. D. 739, T. B. 48-20-1324. Such cost constitutes a part of the cost of the property.

[70] Reg. 45, Art. 293. Such amounts are a part of the cost of the building.

(4) Commissions paid in purchasing securities;[71]

(5) Amounts to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to be used in a reorganization of the corporation;[72]

(6) An assessment paid by a stockholder of a national bank on account of his statutory liability;[73]

(7) Expenditures of a railroad for sidings and spur tracks;[74]

(8) State bar examination fees and traveling expenses incurred and paid by a lawyer in securing admission to practice his profession;[75]

(9) Amounts expended for improvements required by the United States public health service to be made on property in order to make it rat proof as a preventive measure against bubonic plague;[76]

(10) Commissions on sales paid by a corporation to an officer or employee in consideration for refraining from engaging in a like business for a stipulated period;[77]

(11) An expenditure in 1920 for the installation of dipping vats for the purpose of complying with a tick-eradication law, it appearing that such vats will be of no profitable use after the time fixed by law for the eradication of the cattle tick;[78]

(12) Bills for material used in the construction of a taxpayer's house left unpaid by an absconding contractor, the taxpayer being required to pay such bills;[79]

(13) The cost of land title abstract books;[80]

(14) Legal expenses paid by a nonresident alien in securing the return of property and income from the Alien Property Custodian;[81]

(15) The expenditure for labor incident to, and the cost of material entering into, the installation of apparatus leased by the owner under a lease by which the lessor is obliged to maintain

[71] Reg. 45, Art. 293. Commissions for selling securities are an offset against selling price.

[72] Reg. 45, Art. 293.

[73] Reg. 45, Art. 293; A. R. R. 588, T. B. 30-21-1744; O. D. 918, T. B. 20-21-1640.

[74] Grand Rapids & Indiana Ry. Co. v. Doyle, 245 Fed. 792, T. D. 2210.

[75] O. D. 452, T. B. 15-28-49.

[76] O. D. 730, T. B. 46-20-1304.

[77] L. O. 1045, T. B. 41-20-1231.

[78] O. D. 738, T. B. 48-20-1322.

[79] O. D. 925, T. B. 21-21-1651.

[80] O. D. 1049, T. B. 39-21-1843.

[81] O. D. 1048, T. B. 39-21-1842.

the apparatus without charge, the value of the apparatus at the expiration of the lease being less than cost of removal;[82] and

(16) A sum paid upon a partnership dissolution to cover a retiring partner's estimated share of future profits.[83]

PUBLIC UTILITIES. In a decision under the 1909 Law it was held that the fact that, under the laws of California, a public utilities corporation is not the owner of the property, but merely intrusted with the use thereof, did not entitle it to more favorable treatment than other corporations. Money received from the consumers to pay for service connections to be laid in public streets was held to be income on which the corporation was held liable to pay a tax, notwithstanding that all or nearly all of the sums so received may have been expended in betterments and extension of its system. Moneys expended for service connections and pipe extensions were regarded as invested in permanent improvements, and as not falling within any of the permitted classes of deductions mentioned in the statute.[84] They were held not to be in the nature of improvements made merely to facilitate the transaction of a growing business, the expenses of which have been held deductible.[85]

EXPENSE OF RESTORING PROPERTY. The Revenue Act of 1918 and the present law both provide expressly, in the case of individuals and corporations, that no deduction shall be allowed in respect of any amount expended in restoring property or in making good the exhaustion thereof on which an allowance is or has been made.[86] This is also a reasonable limitation, since if such property is subject to wear or tear or depletion. the additional amount so invested in the property may be taken into consideration in computing the allowance for depreciation or depletion. The cost of remodeling buildings for manufacturing a different product is such a capital expenditure.[87]

INSURANCE ON EMPLOYEES. No deduction is permitted for any amount paid in premiums on any life insurance policy covering the life of any employee or any person financially interested in any trade or business carried on by the taxpayer, when the tax-

[82] O. D. 1082, T. B. 44-21-1894.

[83] O. D. 1033, T. B. 37-21-1820. Such a payment is additional cost of the retiring partner's share of assets and should be apportioned to the various assets acquired.

[84] Union Hollywood Water Co. v. Carter, 238 Fed. 329.

[85] See Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

[86] Revenue Act of 1921, §§ 215 (c), 235; Revenue Act of 1918, §§ 215, 235.

[87] See O. D. 1001, T. B. 34-21-1780.

payer is directly or indirectly a beneficiary under such policy.[88] But if the taxpayer is in no sense a beneficiary under such a policy, except as he may derive advantage from the increased efficiency of the employee, and pays the premiums purely as reasonable additional compensation of such employee, they are allowable deductions. Under the 1918 Law whether the proceeds of such policies paid upon the death of the insured might be excluded from gross income or must be included therein depends upon whether the beneficiary was an individual or a corporation.[89] But under the present law they may be excluded by either an individual or corporation.[90] Where a corporation insures the life of its president, the stockholders being beneficiaries in proportion to their stockholdings and the wife of the president (not herself a stockholder) being a beneficiary in proportion to her husband's stockholdings, no deduction for the payment of premiums can be allowed since the corporation itself is indirectly a beneficiary under the policy. The premiums paid on such a policy are a charge against surplus and represent dividends to the stockholders to the extent that such premiums are paid out of earnings or surplus accumulated since February 28, 1913. This applies as well to the officer upon whose life the insurance is carried.[91] The rule as to the deductibility of premiums paid on insurance carried by a corporation upon the lives of its officers or employees, where the corporation is itself the beneficiary, is not altered by the form of the policy taken out. Consequently premiums paid on term insurance policies as well as on life and endowment policies under the conditions stated are not deductible in computing the net income of the corporation subject to tax.[92] A corporation which, in order to protect itself against the loss of services of a valuable salesman, increased his salary with the understanding

[88] Revenue Act of 1921, §§ 215, 235; Revenue Act of 1918, §§ 215 (d), 235 It was held by the Treasury Department that the corresponding provision of the 1916 Law, as amended (Revenue Act of 1916, § 32, added by Revenue Act of 1917), applied to all forms of life insurance, the premiums upon which the individual, partnership or corporation might pay, whoever might be the beneficiaries. (Reg. 33 Rev., Art. 236.) Prior to the passage of this provision it was held by the Treasury Department that such premiums were deductible (T. D. 2090.) This ruling was subsequently reversed and it was held thereafter that premiums were not deductible (T. D. 2519, dated August 30, 1917.) It seems, from the language of this latter Treasury Decision, that it was not intended to have a retroactive effect for years prior to 1917.

[89] See Reg. 45, Art. 294, as amended by T. D. 3019, T. B. 22-20-972.

[90] See Revenue Act of 1921, §§ 213 (b) 233. See Chapters 14 and 20.

[91] O. D. 659, T. B. 37-20-1193.

[92] O. D. 699, T. B. 43-20-1261.

that he would take out a life insurance policy in favor of the corporation and pay the premiums thereon, may deduct only so much of the salary as is in excess of the premiums paid inasmuch as the corporation is the beneficiary under the policy and in reality pays the premiums thereon by reason of having increased the employee's salary for that express purpose.[93] Premiums paid by a corporation on the life of a guarantor of a debt or a debtor to the corporation are deductible, the amount received as a distribution of surplus by the insurance company being income, as well as any excess of any amounts received in the policy over its cash surrender value on March 1, 1913.[94]

When a taxpayer borrows money for business purposes and is required to take out life insurance in favor of his creditor as security for the loan, the premiums paid for such insurance may be deducted as a business expense until the maturity and payment of the loan. This rule does not apply unless the policy was taken out for the sole purpose of using it as security for the loan. A taxpayer is not permitted to deduct the premiums paid on a policy taken out prior to the negotiations for a loan and later assigned to the lender as security for such loan. The subsequent assignment of the policy to the lender is merely incidental to the purpose for which the policy was secured, and no additional expense is incurred or loss sustained by virtue of its temporary use as collateral. The increase in the cash surrender value of a policy accruing during the period it is used as collateral is not to be considered in computing the net income of the person who pays the premium. A corporation which takes out a policy on the life of one of its officers for the purpose of using the policy as collateral may not deduct the premiums paid thereon.[95]

In case a loan is renewed for the full amount, and a policy of insurance taken out in favor of the lender for the express purpose of securing the loan is continued as security, the premium paid thereon by an individual taxpayer is deductible as a business expense under the same conditions applicable in the case of the original loan.

If partial payment is made upon the maturity of the loan, and the loan is renewed for the reduced amount, the premium paid is deductible only to the extent that it is paid on insurance required as security for the reduced amount of the loan.[96]

[93] O. D. 688, T. B. 42-20-1247.

[94] O. D. 1109, T. B. 47-21-1938; O. D. 38, T. B. 1-19-55.

[95] O. D. 711, T. B. 44-20-1276; O. D. 396, T. B. 6-20-726; O. D. 1011, T. B. 35-21-1791.

[96] O. D. 843, T. B. 11-21-1507.

Special Assessments Against Local Benefits. Although assessments against local benefits are frequently referred to as taxes, and are imposed by local governments, they are not deductible as taxes, if "of a kind tending to increase the value of the property assessed."[97] The quoted words were added by the Revenue Act of 1918, and are continued in the present law. Under the 1916 Law, which did not contain this provision, such assessments as, for instance, for paving, curbing, installing sewerage and water systems, etc., were held to be expenditures which add to the value of the property and were required to be capitalized, that is, added to the cost of the property for the purpose of determining the loss or gain in a subsequent sale of such property.[98]

Shrinkage in Value of Life or Terminable Interest Acquired by Gift, Bequest or Inheritance. Under a new provision of the Revenue Act of 1921 amounts paid under the laws of any state, territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance may not be reduced or diminished by any deduction for shrinkage (by whatever named called) in the value of such interest due to the lapse of time, nor by any deduction allowed by the Revenue Act of 1921 for the purpose of computing the net income of an estate or trust but not allowed under the laws of such state, territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.[99]

97 Revenue Act of 1921, §§ 214 (a) 3, 234 (a) 3; Revenue Act of 1918, §§ 214 (a) 3; 234 (a) 3.

98 Letter from Treasury Department dated December 22, 1914; I. T. S 1919, ¶ 1883.

99 Revenue Act of 1921, § 215 (b).

CHAPTER 22

DEDUCTION OF BUSINESS EXPENSES

The Revenue Act of 1921, like the Revenue Act of 1918, permits to corporations the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.[1] The two laws permit individuals the same deduction, except that the property with respect to which rentals, or other payments required to be made, may be deducted, must be used "for purposes of the trade or business" carried on by the individual,[2] and that the 1921 Law contains a provision which was not contained in the 1918 Law, permitting individuals to deduct traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business.[3] The deduction of business expenses is allowed in the case of nonresident aliens and nonresident foreign corporations if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of their deduction with respect to sources of income within and without the United States must be determined in accordance with the statute and under rules and regulations prescribed by the Commissioner with the approval of the secretary.[4] The special provisions applicable to nonresident aliens,

1 Revenue Act of 1921, § 234 (a) 1; Revenue Act of 1918, § 234 (a) 1.

2 Revenue Act of 1921, § 214 (a) 1; Revenue Act of 1918, § 214 (a) 1.

3 Revenue Act of 1921, § 214 (a) 1. See Chapter 21, as to traveling expenses.

4 Revenue Act of 1921, §§ 214 (b) and 234 (b); Revenue Act of 1918, §§ 214 (b) and 234 (b). The 1916 Law permitted to individuals the deduction of the "necessary expenses actually paid in carrying on any business or trade," (Revenue Act of 1916, § 5 (a)), and in the case of corporations all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken, or is not taking, title or in which it has no equity.[5] The Revenue Acts of 1918 and 1921 further qualify the expenses deductible as stated in

and domestic corporations and foreign corporations are discussed in the chapters on these subjects. The discussion in this chapter is limited to the rules applying generally to all taxpayers. As a general rule, the expenses which may be deducted are those necessary for the creation of the income which is taxed. It should be noted, however, that the language of the law contains some express limitations, which are more fully discussed in the following paragraphs.

"Ordinary and Necessary Expenses." Both the 1918 Law and the 1921 Law provide for the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[5] The Revenue Act of 1916 provided for the deduction by corporations of "all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties."[6] Under the 1916 Law it has been held that three conditions are imposed by the Congress upon the allowance of a deduction under this heading: First, the deduction claimed must be for "expenses * * * in the maintenance and operation of its business and properties"; second, they must be "ordinary"; and third, they must be "necessary." If they are not expenses in the maintenance and operation of the business and properties of the corporation they are not deductible.

To be deductible, expenditures must consist of that which is spent or expended or the cost involved in the maintenance and operation of the business and properties.

It is not enough that a deduction claimed should be expenses. They must also be "ordinary *and* necessary." The use of the co-ordinate conjunction requires that "expenses" to be deductible be both "ordinary" and "necessary." Neither qualification alone satisfies the requirement of the statute. "Ordinary" is defined by Webster's dictionary as "common, usual, often recurring."

Construing the phrase "ordinary and necessary expenses" in the connection in which it is used, it seems that the deduc-

the text above by stipulating that they all be "ordinary" as well as "necessary," allows their deduction if "incurred" as well as "paid" omitting the word "actually" in connection with the word "paid." (Revenue Act of 1916, § 12 (a).) In the case of nonresident aliens the deduction was limited to business conducted within the United States and in the case of foreign corporations to business and property within the United States.

[5] Revenue Act of 1918, §§ 214 (a) 1, and 234 (a) (1); Revenue Act of 1921, §§ 214 (a) (1) and 234 (a) (1).

[6] Revenue Act of 1916, § 12 (a).

tion intended to be allowed is only of the usual or common and essential or reasonably necessary expenses in the case of a corporation doing a similar kind and volume of business, and, by implication, that extraordinary or unnecessary expenditures in the maintenance or operation of the business or properties are excluded. Nor, it seems, can the words "ordinary and necessary" be construed as referring to the character of the expenses only and not also their amount. To the popular mind "ordinary and necessary expenses" of a corporation are those which are usual and essential to the doing of a like kind and volume of business by corporations generally.

Under this definition of "ordinary and necessary expenses," the question of whether or not an expenditure claimed as a deduction is legally obligatory upon the corporation and the question of the date when the contract was entered into with reference to the incidence of the taxing act and the motive in entering into the contract would all seem to be immaterial.[7]

Business Expenses. Business expenses, whether subtracted from total receipts in computing gross income or deducted from gross income in computing net income, include all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses, except such items as are otherwise allowed by the law as deductions. Among the items to be treated as business expenses are material, labor, supplies and repairs in the case of a manufacturer, while a merchant would include his purchases of goods bought for resale. In either case the amount to be taken as a deduction in any year should be determined by taking into consideration the inventory at the beginning and end of the year. Other items that may be included as business expenses are reasonable compensation for the services of officers and employees, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident or other similar losses in the case of a business, and rental for the use of business property. A taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source.[8]

[7] L. O. 1045, T. B. 41-20-1241. For a definition of the term "expense" see People v. Board of Supervisors, 60 N. Y. Supp. 1122. For a definition of the word "necessary" as excluding "extraordinary," see Chicago A. R. R. v. House, 172 Ill. 601, 50 N. E. 151; Brown v. City of Corry, 175 Pa. St. 528, 34 Atl. 854, 855. See also Mayor, etc., of City of Baltimore v. Chesapeake & Potomac Telephone Co., 92 Md. 692, 48 Atl. 465, 468.

[8] Reg. 45, Art. 101. The 1916 Law permitted the deduction by corporations of "all the ordinary and necessary expenses paid * * * in the

Where in addition to his salary as an employee, a taxpayer receives sundry amounts from various periodicals for articles contributed by him, his activities in this respect being sufficiently frequent to constitute his writing a business, it has been held that the expenses incurred for information services, magazines, stationery, and supplies used in connection with the production of the articles referred to may be deducted as a business expense, but the cost of books is held to be a capital expense and as such not deductible. There may be taken as a deduction an amount representing depreciation on books, typewriter, furniture, and other equipment of a permanent character in proportion to their use in connection with the production of such articles, providing, however, that no other deduction in respect thereof has been or is being claimed in a return. When trips are made for the express purpose of securing facts for an article, there may be deducted from gross income the reasonable and necessary traveling expenses including railroad fares, as well as expenses for meals and lodging.[9]

Under an option to purchase or so-called "bond and lease" agreement concerning mineral property providing for the payment of royalties on ore mined and for the payment at stated times of the amounts necessary to bring the total amounts paid to certain specified sums, and giving an option to the purchaser to take title to the property upon the payment of a specified amount upon which the royalties and deficiency payments are credited as part of the purchase price, the amounts paid as royalties constitute operating expenses and are deductible as such in determining net income. The additional sums paid to make up the amounts of the several installments when due are capital investments in the nature of bonuses recoverable

maintenance and operation of its business and properties." The 1918 Law permits the deduction by corporations of "all the ordinary and necessary expenses paid * * * in carrying on any trade or business," which seems to be a broader phrase than that used in the 1916 Law. (Compare Revenue Act of 1916, § 12 (a) with Revenue Act of 1918, § 234 (a) 1.) Expenses of operation were held under the 1916 Law to include all expenditures for material, labor, fuel, and other items entering into the cost of the goods sold or inventoried at the end of the year, and all other expenses incurred in the operation of the business, except such as were required by the act to be segregated in the return (Reg. 33, Art. 114), or had been considered in determining the cost. (Grand Rapids, etc. Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.)

[9] O. D. 805, T. B. 7-21-1446. As to the deductibility of traveling expenses see Chapter 21.

through deductions for depletion, computed upon the total sum of such additional payments to the end of the tax year.[10]

As the bonus paid for delivery of a steamship at a date earlier than that contracted for adds nothing to the value of the vessel after the contract date of delivery the amount so paid is properly chargeable as a business expense and is deductible from income received between the date of delivery of the vessel and the date it would have been delivered had no bonus been paid.[11]

Where an officer of a bank was appointed receiver and trustee of an insolvent debtor of the bank, and before accepting office, agreed that he would turn over to the bank whatever compensation he received, it has been held that the amount of compensation so received by the officer during the taxable year should be reported by him as gross income, and that the amount of such compensation turned over to the bank in accordance with the agreement referred to may be deducted by him as a business expense.[12]

In addition to the above the following items have been held deductible as business expenses: (1) Fees paid to secure employment;[13] (2) dues paid to an organized labor union;[14] (3) amounts expended by members of Congress for clerk hire in excess of the allowance made by the government;[15] (4) expenses incurred by a taxpayer engaged in trade or business in making a trip to Washington in connection with an additional tax assessed by the bureau of internal revenue, upon his trade or business;[16] (5) amounts expended for office rent and clerical help by a taxpayer whose income is derived principally from investments in stocks and bonds, if he can show in his return that such expenses are ordinary and necessary within the meaning of the statute;[17] (6) the subscription price paid by a taxpayer for a technical magazine or trade journal to be used by him as a means of furthering his business interests;[18] (7) the payment of an addition to tax for delinquency in filing a return when such addi-

[10] Sol. Op. 86, T. B. 4-21-1406.
[11] O. D. 664, T. B. 38-20-1203.
[12] O. D. 1009, T. B. 35-21-1789.
[13] O. D. 579, T. B. 28-20-1055.
[14] O. D. 450, T. B. 15-20-846.
[15] O. D. 310, T. B. 25-19-583.
[16] O. D. 849, T. B. 12-21-1518.
[17] O. D. 877, T. B. 16-21-1576.
[18] O. D. 785, T. B. 5-21-1417.

tion is incident to carrying on a business or trade;[19] (8) the cost of erecting a portion of a siding from a railroad to his property borne by a taxpayer, the siding to be owned and operated by the railroad;[20] (9) an amount expended by a taxpayer for attorney's fees in defending a suit for negligence brought by a tenant injured on the taxpayer's farm.[21]

The following items have been held not to be deductible as business expenses: (1) The cost of transportation paid by a salaried employee living at a distance from his employment in order to go and return from such employment;[22] (2) amounts expended in defending a suit for damages alleged to have been caused by the negligent operation of an automobile owned and operated for personal convenience.[23] Where ships in process of construction under contract were requisitioned by the shipping board, completed, and then reconveyed to the company from which they were requisitioned for an amount in excess of the contract price, the entire cost is held to be a capital expenditure and the excess of the cost over the contract price is not deductible as a loss or a business expense.[24]

BUSINESS EXPENSES CONNECTED WITH LEASEHOLD PROPERTY. The law provides for the deduction as expense of rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business in the case of an individual, and in all cases by corporations, of property to which the taxpayer has not taken or is not taking title, or in which he has no equity.[25] Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run.[26] Not only is rent paid for business property deductible as an expense, but also amounts paid to secure immediate possession of property purchased from a tenant in possession. Sums so paid should be spread as a deduction in equal amounts over

[19] O. 926, T. B. 23-19-551. The payment of an addition to tax because of a false or fraudulent return may not ordinarily be deducted in the case of an individual who himself was guilty of making a fraudulent return.

[20] O. D. 1019, T. B. 36-21-1800.

[21] O. D. 1117, T. B. 48-21-1947.

[22] S. 1048, T. B. 8-19-317. Such cost is held to be a personal expense.

[23] A. R. R. 444, T. B. 12-21-1527.

[24] O. D. 851, T. B. 12-21-1520.

[25] Revenue Act of 1921, §§ 214 (a) 1 and 234 (a) 1; Revenue Act of 1918, §§ 214 (a) 1 and 234 (a) 1.

[26] Reg. 45, Art. 109; T. D. 3062, T. B. 37-20-1198.

the term of the outstanding lease.[27] Where a lessor pays a fixed sum to secure the cancellation of a lease on business property, the sum so paid is an allowable deduction in aliquot parts for the year of cancellation and the succeeding years of the life of the lease.[28] Attorneys' fees in connection with securing such a cancellation are also a proper deduction.[29] Where the lessee of business premises pays to the lessor as damages a lump sum in consideration of the lessor's cancellation of a lease for a term of years, the sum paid equalling a certain amount for each month of the unexpired term, it is held that the amount paid is an allowable deduction as a business expense. The amount of the damages is deductible for the year in which actually paid or accrued depending upon the method of accounting employed.[30] The expense of restoring property at the expiration of a lease is an allowable deduction only in the year in which it is actually incurred.[31] The value as of March 1, 1913, of a leasehold acquired prior to that date, can not be used in determining the amount deductible each year by the lessee when the leasehold was acquired on the basis of annual rental payments equal to a percentage of the income derived from the leased property, no specified sum having been paid in addition to the annual rentals. The amount deductible by the lessee each year is the rental payment.[32] A lessor of residential property is entitled to deduct the water rent paid in the District of Columbia on such property, since in such case the rent is a business expense incident to the lease of the property. Where water rent is paid on residential property by the person occupying it as such, it becomes a personal expense and is not an allowable deduction.[33]

Advertising Expenses. A corporation may deduct the expenses of a national campaign of advertising its manufactured product in the year in which paid or accrued and may not carry such expenses as a deferred asset and charge them off over a period of years.[34] Amounts expended in outfitting a baseball team which represents the taxpayer, and the uniforms

[27] O. D. 585, T. B. 28-20-1061.
[28] O. D. 397, T. B. 6-20-727; A. R. R. 178, T. B. 28-20-1054.
[29] A. R. R. 178, T. B. 28-20-1054.
[30] O. D. 974, T. B. 28-21-1726.
[31] O. D. 516, T. B. 21-20-952.
[32] O. D. 675, T. B. 40-20-1220.
[33] O. D. 719, T. B. 45-20-1291.
[34] O. D. 1039, T. B. 38-21-1829.

of which bear the name of the taxpayer the players represent, if considerable publicity is thereby obtained, may be deducted like other advertising expenses.[35]

Expenses Relating to Patents. A royalty paid by a corporation to one of its officers, who is also a majority stockholder, for the use of a patent upon an article manufactured and sold by the corporation is deductible as a business expense, provided the amount so paid is reasonable, considering the value of the invention and its salability in the open market. Any payment so made in excess of a reasonable amount would represent a distribution of profits, and consequently would not be deductible.[36] Amounts expended by a corporation in litigation defending its right, title, and interest in a patent after the patent has been issued are not a part of the cost of the patent and thus capital expenditure; such amounts may consequently be deducted as an operating expense.[37]

Professional Expenses. A professional man may claim as the cost of supplies used by him in the practice of his profession, expenses paid in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid for office rooms, the expense of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistants. Amounts expended for books, furniture and professional instruments and equipment of a permanent character are not allowable as deductions.[38] A professional singer may not deduct payments to a throat specialist.[39]

Rent for Residential Property. In the case of a professional man who rents property for residential purposes but receives there clients, patients, or callers in connection with his professional work (his place of business being elsewhere) no part of the rent is deductible as expense.[40]

Cost of Manufacturing Products. A manufacturer might, under the 1916 Law, include as elements of the cost of manufactured products, the cost of raw material, the labor cost of the men actually working on such products, as well as the cost of supervisory labor such as that of foremen, inspectors, overseers, etc., provided such expenditures were not separately deducted

[35] O. D. 1030, T. B. 37-21-1815.
[36] O. D. 440, T. B. 14-20-835.
[37] A. R. R. 98, T. B. 20-20-934.
[38] Reg. 45, Art. 104.
[39] O. D. 1032, T. B. 37-21-1819.
[40] Reg. 33 Rev., Art. 8.

from gross income.[41] This ruling permits certain items of wages and salaries to be included in the cost of the manufactured product, or to be separately listed as labor, wages, commissions, etc.

Cost of Materials. Taxpayers carrying materials and supplies on hand should deduct as expenses the charges for materials and supplies only to the amount that they are actually consumed and used in operation during the year for which the return is made, provided that the cost of such material and supplies has not been taken into account in determining net income for any previous year. If a taxpayer carries materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to deduct from gross income as expenses the total cost of such supplies and materials as were purchased during the year for which the return is made, provided the net income is clearly reflected by this method.[42]

Repairs. Incidental repairs made to the business property of a taxpayer, which neither add to the value of the property nor appreciably prolong its life, but keep it in an operating condition, are deductible as expense, provided the plant or property account is not increased by the amount of such expenditures.[43] This is true of repairs made by a lessee of property who by the terms of the lease is required to return the leased properties at the end of the lease in the same condition they were in at the date of the lease.[44] Expenditures for replacing worn-out parts such as gears, bolts, nuts, valves, etc., so long as such replacements are not pursued to the extent of, and for the purpose of finally restoring the machinery or equipment as a whole, constitute incidental repairs and are deductible as operating expenses. In addition, depreciation on the property so repaired may be claimed in order to replace the machinery, equipment or building when, as an entirety, it is worn out or is worthless for the purpose for which it is intended.[45]

[41] T. D. 2152.

[42] Reg. 45, Art. 102.

[43] Reg. 33, Art. 131; Reg. 45, Art. 103. Maintenance means the upkeep or preserving of the condition of the property to be operated and does not mean additions to the equipment, property or improvements of former condition of the property. Grand Rapids, etc., Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

[44] O. D. 1014, T. B. 35-21-1794.

[45] Reg. 45, Art. 103. Letter from treasury department dated September 19, 1916.

Where a corporation engaged in buying and selling real estate purchases a piece of property and holds it for a profit, the interest, taxes, and ordinary repairs incident to the property represent charges for the year in which paid or are so charged upon the books as to represent liabilities of the corporation and are allowable deductions in computing net income even though in excess of the gross income derived from the property. Such charges are not capital expenditures if the corporation has any income from which to deduct them and they should not be added to the cost of the property in determining the amount of gain or loss arising from its sale except to the extent that the corporation has no gross income from any source against which to deduct such expenditures for the taxable year in which they were made.[46]

Office Furniture and Equipment. An ordinary amount expended for renewal of office furniture and equipment, and charged to expense, has been held not to be invested in assets, but to be a proper expense of maintenance of the business of an insurance company, which it was entitled to deduct in ascertaining its taxable net income under the 1909 Law. The company had expended in one year $1,213 for ordinary renewals of office furniture, in another year $1,379, and an additional sum of $1,808 for ordinary renewals of attendants' uniforms, door mats, window shades, awning, small hardware, oils and other articles of like character and also the sum of $2,244 for ordinary renewals of office equipment, consisting of lamps, alterations of fixtures, shades, meters, fans, plugs, wirings, etc., and these expenditures were no greater than the average of similar expenditures for other years and did not exceed 5% of the cost of all the plaintiff's existing furniture and equipment similar to the articles detailed, and none of the items was considered in the corporation's books or statement as assets because of their rapid depreciation. The articles mentioned were of a perishable and transient nature, and properly charged to expense of maintenance, since they apparently did no more than maintain in proper condition and repair the ordinary equipment of office furniture and supplies.[47]

Expenditures for Alterations. In the case of a company which expended approximately $5,000 for alterations in its home office, apparently solely with a view of facilitating the carrying

[46] O. D. 398, T. B. 6-20-728.

[47] Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

on of its business, it was held under the 1909 Law that such amount was properly deducted as an expense. The court said in part: "It should be remembered, also, that in these days of up-to-date business method requirements it often becomes necessary for business concerns to change the lay-out and appointments of the places wherein they carry on business, with a view to economy in space, a saving of unnecessary labor, and the bettering of working conditions of employees, to the end that a net saving of running expenses will result. In view of the consistent expansion of the plaintiff's business, which the evidence shows, it would seem that the amount expended for the changes made in the office ought not, under the circumstances, to be considered unreasonable or unusual, and that, therefore, the amount claimed might well have been allowed as an item of deduction. It seems to the court that business concerns, in matters of this kind, should be allowed a reasonable discretion, and the law so enforced as to help rather than to hinder them in making reasonable progress in the development of their business, for it must appear to any one giving the matter a moment's consideration that the more successful a business the larger the results, even from the standpoint of taxes accruing to the government."[48]

Repairs and Improvements Made by a Tenant. Where a lease requires the tenant to make all necessary repairs or improvements, which repairs or improvements revert to the landlord at the expiration of the lease, the tenant may charge the cost of all such repairs and improvements as an expense of doing business. If the improvements are somewhat permanent in character, the expense should not be all deducted in one year, but should be prorated over the number of years constituting the term of the lease, and the amount deductible in each year would be the aliquot part of such cost.[49] Taxes or other expenses paid by the tenant for the landlord should be deducted by the tenant as expense.

Cost of Buildings Erected by Tenant Under Terms of Lease. Where under the terms of a lease, a tenant agrees to erect a building, or to expend during the rental period a fixed sum in making improvements upon the freehold, the building or permanent improvements become a part of the realty, unless otherwise agreed upon between the contracting parties. As the use of the building or permanent improvement by the tenant,

[48] Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206.
[49] T. D. 2137.

during the term of the lease, is a part of the consideration of the contract, the cost of such buildings or improvements may be prorated by the tenant over the leased term and deducted, at an annual rate, as a part of the necessary expenses actually paid in carrying on any business or trade. The tenant may also deduct the cost of incidental repairs and maintenance to such buildings and improvements, but no depreciation may be claimed with respect to such buildings and improvements.[50] If the building is erected, or permanent improvements are made after the lease is partially expired, the cost thereof may be divided by the number of years the lease then has to run, and if the life of the lease is longer than the estimated life of the building or improvements, the cost may be divided by the number of years such building or improvements are expected to last, instead of the number of years constituting the life of the lease.[51]

Buildings Used for Rental Purposes. A landlord may claim as an expense any amounts expended for maintenance of the property or its use for rental purposes, including amounts paid for repairs, insurance, fuel, light and water, and janitor and elevator service, if any.[52] Where the landlord occupies a part of the building as his own dwelling he should not deduct such proportion of the expenses of operating the building as inure to his personal benefit, as that part constitutes personal or living expenses which are not deductible. Thus, if a landlord lives in one-half of the building, one-half of the expenses are not an allowable deduction in his return.

Reserves. Payments by a corporation to a trustee during a taxable year and set aside for a "maintenance fund" to be controlled solely by the trustee pursuant to a provision in the bylaws of the company requiring such payments, are not deductible. Such amounts held by the trustee and accumulated are an asset of the corporation and any gain accruing therefrom is income of the corporation.[53]

Insurance on Property. Insurance premiums paid on property used for business purposes, or rented or leased to secure an income, are an allowable deduction.[54] Premiums on crop insurance

[50] Reg. 45, Art. 109; T. D. 2442; Reg. 33, Art. 115; T. D. 3062; T. B. 37-20-1198; A. R. R. 384, T. B. 7-21-1456.

[51] Reg. 45, Art. 109; letter from treasury department dated February 27, 1917; I. T. S. 1918, ¶ 1506.

[52] Letter from the treasury department dated February 26, 1915; I. T. S. 1919, ¶ 920.

[53] O. D. 1047, T. B. 39-21-1840.

[54] Reg. 45, Art. 101; T. D. 2090.

taken out as a protection against a loss on account of crop conditions are deductible as a business expense.[55]

Fidelity Insurance. Where an employee is required to furnish a bond and pay the premium thereon, as a necessary incident to his employment, the amount so paid may be deducted by him as an expense.[56] Thus premiums paid on indemnity bonds furnished by government employees for the faithful performance of their duties constitute allowable deductions.[57] If the employer pays the premium it may be included in his business expense.

Insurance Reserves. Funds set aside by a corporation for insuring its own property are not a proper deduction as a business expense, but any loss actually sustained may be deducted, although actually paid out of a fund so set aside.[58]

Insurance Under Workmen's Compensation Law. Under the Workmen's Compensation Law of a state, employers are required either to make periodical payments to the state insurance fund created to compensate employees for injuries received in the course of their employment, or to maintain a benefit fund providing for the payment of such compensation, giving a bond as additional security for the payment of such compensation. Where the employer makes the periodical payments to the insurance fund of a state such payments are allowable deductions for the year in which paid or accrued. If, however, the employer maintains a fund actually depositing periodically in a trust company an amount to be held in reserve as a special fund for the payment of compensation as injuries occur, the amount thus deposited is not an allowable deduction from gross income, since there is no means of determining how much of this fund will be used for the purpose for which it is held. In such case the actual amount paid during a year to the employees as compensation where injuries occur is a proper deduction for that year whether the amount so paid is greater or less than the deposits made during the period to the fund which is maintained.[59]

Subtraction for Redemption of Trading Stamps. Where a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such

[55] O. D. 215, T. B. 11-19-377.
[56] T. D. 2090.
[57] O. D. 878, T. B. 16-21-1577.
[58] Reg. 33, Art. 122.
[59] O. D. 964, T. B. 27-21-1712.

sales subtract only the amount received or receivable which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users engaged in similar businesses. The taxpayer should file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing (a) the total issue of stamps during each year, (b) the total stamps redeemed in each year, and (c) the percentage for each year of the stamps redeemed to the stamps issued in such year. A similar statement should also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive an amended return or amended returns will be required.[60]

Propaganda Expenses. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income.[61]

Commissions. Commissions paid to a real estate agent for collecting rents and managing property are allowed as a business expense to the owner. Commissions paid to salesmen as a part of the expense of conducting business are also allowed as a deduction.[62] Commissions paid in purchasing and selling securities are a part of the cost or selling price of the securities and are not otherwise deductible.[63] Advances made to salesmen during a taxable year in excess of commissions earned constitute an allowable deduction, where the taxpayer is obligated under its contracts with its salesmen to make such advances as long as they remain in its employ, and where such advances will never be repaid except to the extent that commissions earned in a subsequent year exceed the guaranteed advances of that year.[64]

[60] Reg 45, Art. 87; Reg. 33 Rev., Art. 141.
[61] Reg. 45, Art. 562; T. D. 2137.
[62] T. D. 2090.
[63] Reg. 45, Art. 293; Reg. 33 Rev., Art. 8.
[64] A. R. R. 374, T. B. 6-21-1429.

Entertainment Money. So-called spending or treating money actually advanced by business enterprises to their traveling salesmen, as a part of the selling expense of their product, is a proper deduction. There must, however, be some showing that all of the allowance claimed as a deduction has been actually expended for the purpose for which the allowance is made, namely, the selling of the product in question.[65] Expenses accrued in furnishing entertainment to the taxpayers' employees by means of picnics or dances are not deductible.[66]

Salaries and Compensation for Personal Services. The 1916 Law did not expressly mention "salaries" in the provisions allowing the deduction of business expenses.[67] The 1921 Law, like the 1918 Law, expressly authorizes the deduction by employers of "a reasonable allowance for salaries or other compensation for personal services actually rendered."[68] The rulings hold the test of deductibility to be whether in fact payments of salaries are reasonable and are purely for services or include "*some other element.*" In the case of any compensation, however determined, which exceeds amounts ordinarily paid for like services in like enterprises under like circumstances, the burden is upon the taxpayer to show that the amount paid is solely the purchase price of services. The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the enterprise and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid. In any event the allowance for compensation

[65] T. D. 2090.

[66] O. D. 1030, T. B. 37-21-1815.

[67] Revenue Act of 1916, § 5 (a) and § 12 (a).

[68] Revenue Act of 1921, §§ 214 (a) (1) and 234 (a) (1); Revenue Act of 1918, §§ 214 (a) and 234 (a). These provisions seem to authorize the Commissioner to disallow such part of any salary payments as appear unreasonable in view of the services rendered, notwithstanding that the salary may actually have been paid under a valid contract.

paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.[69]

The problem of determining reasonable compensation for personal services is one of difficulty, in that there are few general rules which can be laid down as guides to a decision. Many factors are involved, such as the character and amount of responsibility, ease or difficulty of the work itself, time required, working conditions, future prospects, living conditions of the locality, individual ability, technical training, profitableness to the employer of the services rendered, and the number of available persons capable of performing the duties of the position. These and other factors have a bearing, and the amount of weight to be attached to each one can be determined only in the light of the circumstances in each particular case.[70] A large number of cases have arisen under the Revenue Act of 1918 and prior laws, dealing with the question of what under the particular facts presented constitutes a reasonable compensation for personal services.[71] The decisions made are of comparatively little general value, but, in addition to the above discussion of the subject, the following general principles should be applied in the determination of the question as it arises in any particular case:

69 T. D. 2696, Reg. 45, Arts. 105, 106. It was held under the 1916 Law that reasonableness was ordinarily the controlling test of the deductibility of salaries determined *after* services had been rendered. In certain instances apparently of this sort it was permitted to be shown that the compensation was fixed according to a custom or practice having virtually the force of a contract. Where this was not true and it was for the management to fix a fair compensation it was assumed that true compensation was only such amount as would ordinarily be paid in like circumstances by similar enterprises; in other words, that the fair criterion was what the recipient could get by rendering the same services to another employer. (T. D. 2696.)

70 T. B. M. 44, T. B. 10-19-362.

71 A. R. R. 31, T. B. 9-20-768; A. R. M. 30, T. B. 9-20-767; A. R. R. 32, T. B. 9-20-769; A. R. M. 39, T. B. 14-20-829; A. R. R. 53, T. B. 14-20-830; A. R. R. 61, T. B. 15-20-847; O. D. 504, T. B. 20-20-935; A. R. R. 223, T. B. 32-20-1119; T. B. M. 86, T. B. 22-19-534; T. B. M. 70, T. B. 18-19-401; T. B. R. 46, T. B. 15-19-444.

1. Each case must be decided on its own merits; there is no warrant for fixing any maximum limit for deductible salaries.[72]

2. Salaries voted before the passage of any excess-profits tax law are subject to a less severe test of reasonableness than salaries voted thereafter and unless they bear a close relationship to stockholdings will almost invariably be allowed.[73]

3. Salaries voted subsequently to the passage of the 1917 Excess-Profits Tax Law will not be disallowed if, after deducting the salaries, the company has left a normal return on invested capital or if the deduction does not reduce the net earnings subject to tax below that of competing concerns which secure the services of officers and employees by open bargaining.[74]

4. If salaries are reasonable in amount in view of all the circumstances, they will not be disallowed even if based on stockholdings. Relationship to stockholdings will not *per se* disqualify salaries; it will require their disallowance only if unreasonable.[75]

5. Generally speaking, salary or compensation agreements made in advance between an enterprise with its officers and employees are not subject to the same degree of scrutiny as agreements made after the services are rendered.[76]

6. In cases where compensation is determined after services have been rendered reasonableness is, ordinarily, the test of deductibility.[77]

7. Salaries voted subsequently to the close of any taxable year and to the closing of the books for such year, in the absence of contract obligation, are not deductible.[78]

8. Salaries will not be considered collectively, but the salaries paid individually will be analyzed carefully to determine their reasonableness and whether they are purely payment for services rendered.[79]

[72] T. B. R. 46, T. B. 15-19-444; A. R. M. 138, T. B. 39-21-1841.

[73] A. R. R. 53, T. B. 14-20-830; A. R. M. 30, T. B. 9-20-767; A. R. R. 346, T. B. 51-20-1352; but see L. O. 1045, T. B. 41-20-1231.

[74] A. R. R. 53, T. B. 14-20-830; but see A. R. R. 223, T. B. 32-20-1119; A. R. R. 435, T. B. 13-21-1528.

[75] A. R. R. 32, T. B. 9-20-769; A. R. M. 30, T. B. 9-20-767.

[76] A. R. R. 31, T. B. 9-20-768; A. R. M. 39, T. B. 14-20-829; but see L. O. 1045, T. B. 41-20-1231.

[77] A. R. R. 61, T. B. 15-20-847; O. D. 504, T. B. 20-20-935.

[78] T. B. M. 86, T. B. 22-19-534; O. D. 497, T. B. 19-20-917; A. R. R. 493, T. B. 20-21-1637; A. R. R. 519, T. B. 22-21-1662.

[79] A. R. M. 138, T. B. 39-21-1841.

9. The amount of salary fixed by a board of directors is presumptively valid, but not conclusively so, and the government has the right to attack the action of the board of directors and show by evidence, not that a given salary is too much, but that, in the circumstances, the whole or some part of it is not salary at all, but is profits diverted to a stockholding officer under the guise of salary.[80]

SALARIES CONSTITUTING A DISTRIBUTION OF DIVIDENDS. Any amount paid in the form of a salary, but not in fact as the purchase price of services is not deductible. In the case of corporations, a salary paid to an officer or employee who is not a stockholder is a proper deduction if it fulfills the requirements stated in the preceding paragraph. Where the officer or employee is also a stockholder, the salary deduction is subjected to closer scrutiny. An ostensible salary may be a distribution of a dividend on stock, especially in the case of a corporation having a few stockholders, practically all of whom draw salaries. If in such a case the salaries are based upon or bear a close relationship to the stockholdings of the officers or employees, the presumption will be that the salaries, if in excess of those ordinarily paid for similar services, are not paid wholly for services rendered, but in part as a distribution of earnings upon the stock.[81] In the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, the amount of the excess should be treated as dividends and would thus be exempt from the normal tax in the hands of the recipients.[82]

[80] U. S. v. Philadelphia Knitting Mills Co., 273 Fed. 65, decided under the 1909 Law. See A. R. M. 138, T. B. 39-21-1841.

[81] Reg. 45, Art. 105. It was first held that the following rules should be observed in connection with such payments: (a) the services must be actually performed, (b) the amount must be no more than a fair and reasonable compensation for services rendered, and (c) the compensation should not depend upon the interest of the officer or employee in the corporation as a stockholder or vary from year to year with the earnings of the corporation. (T. D. 2152; letter from treasury department dated February 2, 1915; I. T. S. 1918, ¶¶ 1389 and 1811.) See subparagraph 9, of the preceding paragraph. Under the 1909 Law it was held that in addition the salary paid to an officer who was a stockholder must be authorized by the board and made a matter of record on the minute book of the corporation, in order to be an allowable deduction. (T. D. 1742.) Where a company was composed of two stockholders who divided the net profits between them, calling it compensation, it has been held by the courts that the money paid out was equivalent to a dividend. (Jacobs and Davies, Inc., v. Anderson, 228 Fed. 505; T. D. 2262.)

[82] Reg. 45, Art. 106; T. D. 2696; O. D. 1012, T. B. 35-21-1792. See also Reg. 33, Art. 119. It is conceivable, of course, that an individual may ren-

SALARIES CONSTITUTING A WASTE OF ASSETS. An ostensible salary paid by a corporation may be in part a waste or appropriation of assets of the corporation, especially where salaried employees are in control of the corporation through holding, directly or indirectly, a majority of its stock. In the case of a large corporation with many stockholders owning a substantial minority of its stock the tendency of officers unduly to inflate their salaries must be taken into account. In such cases payments representing a waste or appropriation of assets of the corporation by officers who control it and fix their compensation in violation of the rights of the corporation are held not to be deductible to the amount of their excess over a reasonable compensation. While disallowed as a deduction to the corporation such payments are required to be treated as compensation of the individuals, subject to the normal tax, compensation illegally secured being none the less subject to tax in all respects.[83]

SALARIES CONSTITUTING PART PAYMENT FOR PROPERTY. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business. The amount of the excess should be treated by the corporation as a capital expenditure and by the recipient as part of the purchase price.[84]

EXCESSIVE PAYMENTS BY INDIVIDUALS OR PARTNERSHIPS. In the case of excessive payments by individuals or partnerships, the amounts disallowed should ordinarily be treated as shares of the profits of a partnership, except that a payment for property should be treated by the individual or partnership as a capital expenditure and by the recipient as part of the purchase price.[85]

der services of great value to a corporation of which he is the chief stockholder and it seems reasonable that he should be entitled to compensation for services he actually performs in addition to his dividends as a stockholder since as a stock holder he is under no duty to devote any part of his time to the business of the corporation.

[83] Reg. 45, Arts. 105, 106. Under the 1916 Law if a compensation contract with the majority stockholder or stockholders was approved by all the stockholders, as well as by the directors, it might however be dealt with like any other contract. (T. D. 2696.)

[84] Reg. 45, Arts. 105, 106.

[85] Reg. 45, Art. 106.

Salaries Paid to Enlisted Men. An individual, partnership or corporation continuing to pay an officer or employee his salary or compensation, or part thereof, while he serves in the United States army or navy or while he has undertaken services for the government at Washington or elsewhere at reduced or nominal compensation, is permitted to deduct the amount as an expense, on the theory that the business purpose of the continuance of such compensation is to preserve the organization and secure the return after the war of such officers or employees.[86]

Compensation Paid to Employees During Absence at Schools. Where a corporation encourages or requires its employees to attend part-time schools it may deduct as a business expense reasonable amounts paid as compensation to such employees during their absence from employment while attending such schools.[87]

Allowances to Minor Children. The father is legally entitled to the services of his minor children. Allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions.[88]

Bonuses and Profit Sharing Payments. The rules and regulations[89] in regard to the deductibility of special payments made as extra compensation to officers or employees of an enterprise,[90] do not permit of a ready determination of every question,[91] but indicate an increasing liberality on the part of the treasury department toward the allowance of such payments as deductions. All such payments to officers or employees having any considerable interest in the profits of the enterprise through stock ownership or otherwise are subject to careful analysis in the same manner as salaries. The scope of this scrutiny has been treated in the foregoing paragraphs. As previously stated, while any form of

[86] Reg. 45, Art. 108; T. D. 2660; letter from treasury department dated October 4, 1916; I. T. S. 1918, ¶ 1391.

[87] O. D. 850, T. B. 12-21-1519.

[88] Reg. 45, Art. 291. See Chapter 21.

[89] Reg. 45, Art. 107; T. D. 2696; T. D. 2616; T. D. 2152; T. D. 2090; Reg. 33 Rev., Arts. 8 and 138; letter from treasury department dated June 25, 1914; I. T. S. 1918, ¶ 1398; mimeograph letter to collectors No. 1314, I. T. S. 1918, ¶ 1401; letter from treasury department dated November 12, 1917; I. T. S. 1918, ¶ 1407.

[90] The later rulings treat the question irrespective of the status of the payor of the bonus, establishing the same rule, so far as deductibility is concerned, in the case of individuals, partnerships and corporations. The term "enterprise" is used in the text to include all these three forms of business activity.

[91] They are said "to indicate a basis of solution" when applied "in the light of full knowledge of the facts in the particular case." (T. D. 2696.)

contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Just as in the case of salaries, the test is whether the payments are made in good faith and are in fact purely for services or include "some other element." Generally speaking, if contingent compensation is paid pursuant to a friendly bargain between the enterprise and the individual, made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, the contingent compensation should be allowed as a deduction; even though in the final working out of the contract it may prove to be greater than the amount which would ordinarily be paid. Reasonableness is ordinarily the controlling test of the deductibility in the case of bonuses and special compensation for services, as in the case of salaries. Summarizing the latest rulings[92] the following rules may be stated as a basis for the determination of the question whether special payments made as extra compensation to officers and employees of an enterprise are deductible under the heading of business expenses: (a) the fundamental test is whether or not such payments are made as compensation for services rendered; (b) if payments of compensation for services rendered are made in pursuance of a contract express or implied (which need not be in writing)[93] or a long-time practice (practically an implied contract), regularly employed, of paying to employees certain sums in addition to their stipulated salaries, constituting a condition, if not a contract, whereby the employees may reasonably expect for greater or better service rendered, additional pay, they are deductible; (c) if payments are made as compensation for services rendered, but not in pursuance of a contract expressed or implied or a long-time practice as above stated, the total amount of salary and extra compensation may not exceed a reasonable compensation for the services rendered; (d) bonuses or additions to salaries voted subsequent to the close of any taxable year and also subsequent to the closing of the books for such taxable year will not be considered such ordinary and necessary expenses of doing business during such year as are deductible.[94] The early

[92] Reg. 45, Art. 107; T. D. 2696.

[93] A written contract is, of course, better evidence in case any question arises.

[94] O. D. 497, T. B. 19-20-917.

condition that payments of bonuses or extra compensation could not be dependent upon the earnings of the paying corporation no longer obtains except insofar as it may throw light upon the question of whether or not the payments in question are made as compensation for services rendered.[95]

In a case in which three officers and principal stockholders of a corporation were paid a commission and salary aggregating 50% of the gross margin on the business developed by each, such commission and salary were held reasonable because the business of the corporation was dependent almost solely upon the personal efforts of such officers.[96]

ADDITIONAL COMPENSATION PAID IN STOCK. Where, for the purpose of distribution as additional compensation to its employees, a corporation purchases its own stock in the open market, the market value of such stock at the time of distribution is the amount which the corporation is entitled to deduct as an ordinary and necessary expense of business assuming, of course, that the compensation is reasonable and proper.[97] A proportionate part of the par value of a company's stock, delivered to a trustee to be held in escrow for the benefit of certain employees of the company, which stock is to be delivered to them at the expiration of a number of years in recognition of faithful service, may be taken as a deduction for each of such years during the period the trustee holds the stock, providing the corporation keeps its books on an accrual basis.

[95] The early rulings held in effect that payments made by a corporation as extra compensation to officers and employees might be deducted: (a) if it was clearly shown that they were made as compensation for services rendered; (b) if they were paid in pursuance of a contract express or implied; (1) the contract need not have been in writing, (2) a long time practice (practically an implied contract), regularly employed, of paying to employees certain sums in addition to their stipulated salaries constituted a condition if not a contract, whereby the employees might reasonably expect, for greater or better services rendered, additional pay and was equivalent to a contract within this heading; (c) if the total amount of salary and extra compensation was not greater than a reasonable compensation for the services rendered; (d) if they were not conditional upon the earnings of the corporation but were conditional or dependent upon the services rendered. (See note 89.) These tests were later modified, as indicated in the text above.

[96] T. B. M. 81, T. B. 23-19-554.

[97] A. R. M. 114, T. B. 11-21-1509. This ruling is based on the department's prior ruling that a corporation realizes no gain or loss from the purchase of its own stock (Reg. 45, Art. 542) and on a ruling holding in a similar case that the employee's additional compensation is the value of the stock when received (O. D. 570, T. B. 27-20-1039).

If the employee for whom the stock was deposited should forfeit his right to receive the stock, the corporation must report as income in the year in which the right to receive the stock is forfeited, the amounts taken as a deduction in previous years on account of the forfeited stock.[98]

GIFTS, GRATUITIES OR DONATIONS TO EMPLOYEES. Gifts or gratuities made by an enterprise to its employees are not proper deductions under the heading of expense. Even where such payments are called extra compensation, if they are in fact gratuitous or voluntary payments for which no services are rendered, their character as gifts is not changed. The custom of paying bonuses or Christmas gifts to employees, even though it has been the practice of the enterprise for a long time to make such gifts, does not render the amount so paid a proper deduction as expense if the gift is purely voluntary and gratuitous.[99] On the other hand, gifts or bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not deductible from gross income.[100]

Pensions. Under the 1916 Law the deduction of amounts paid as pensions was allowed or disallowed upon the basis of the general provisions[101] of that law permitting the deduction of all the necessary expenses of individuals in carrying on any business or trade and the ordinary and necessary expenses of corporations paid in the management and operation of their business and properties. The Revenue Acts of 1921 and 1918 expressly provide[102] that these expenses include "a reasonable allowance for salaries and other compensation for personal services actually rendered." But the intent is probably not to exclude pensions by reason of services which have been rendered. It has been ruled that amounts paid for pensions to retired employees or to their families or others dependent upon them, or on account of injuries

[98] O. D. 124, T. B. 3-19-186.

[99] Reg. 45, Art. 107. See T. D. 2090; T. D. 2152; mimeograph letter to collectors, No. 1314; I. T. S. 1918, ¶ 1407.

[100] Reg. 45, Art. 107.

[101] Revenue Act of 1916, §§ 5a and 12a.

[102] Revenue Act of 1921, §§ 214 (a) (1) and 234 (a) (1); Revenue Act of 1918, §§ 214 (a) 1 and 234 (a) 1.

received by employees, and lump sum amounts paid as compensation for injuries, are a proper deduction as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. No deduction may be made for contributions to a pension fund held by the corporation, the amount deductible in such case being the amount actually paid to the employee. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs in recognition of the services rendered by the individual, such payments may be deducted.[103]

Donations. Donations by business concerns may or may not be held to be proper deductions as expense. There must be a consideration in some form to take the donation out of the class of gratuities. When a donation legitimately represents a consideration for a benefit flowing, directly or indirectly, to the donor, as an incident of its business, it is an allowable deduction. It has been held that a corporation engaged in the agricultural business can not be allowed to make deductions on account of donations to fairs, churches, and associations; such donations, although made for the purpose of obtaining and preserving the good-will of the farmers, being mere gratuities. Where a street railway company donates a sum of money to an organization intending to hold a convention in the city in which the company operates, with the expectation that the holding of such convention will augment its income because a greater number of people will use its street cars, the donation has been held to be deductible. A donation to a hospital, under agreement that employees of the donor are to have a ward for their use in case of accident or illness, is a proper deduction. Donations made for purposes connected with the operation of the business, when limited to charitable institutions, hospitals or educational institutions, conducted for the benefit of employees or their dependents, are within this class, but such donations should be reduced by any amount repaid to the corporation by the employees. Expenses incurred in advertising and promoting the sale of Liberty bonds and war savings stamps over the corporation's name were held deductible.[104]

[103] Reg. 45, Art. 108. This reverses the earlier rulings of the treasury department regarding salaries paid to the widow or heirs of the employee after his death. (Reg. 33 Rev., Art. 136; T. D. 2090.)

[104] Reg. 45, Art. 562; T. D. 2847; Reg. 33 Rev., Art. 134; letter from treasury department dated May 23, 1918; I. T. S. 1918, ¶ 3437; telegram from treasury department dated May 23, 1918; I. T. S. 1918, ¶ 3436; O. D. 682, T. B. 41-20-1236.

Donations made to the American Red Cross, United War Workers, Liberty loan drives and the Salvation Army are held not to be deductible as business expenses. Donations made by industrial and railway corporations to the Young Men's Christian Associations are held not to be deductible even where the associations are located on the property of these corporations and are operated for the benefit of the employees of such corporations.[105]

A corporation may not deduct the amount paid into a pension fund for the benefit of its employees in the taxable year. This rule obtains, although the corporation constitutes itself a trustee of the sum contributed to pay the income thereof to its employees, but reserving absolute discretion as to the selection of the employees to be benefited.[106] Donations by a corporation to a pension fund for the benefit of its officers and employees, the fund being organized entirely separate and distinct from the corporation, having its own set of books, making its own investments, and paying its own expenses, legal title of which does not remain in the corporation, are deemed to be donations to a charitable institution conducted for the benefit of the corporation's employees or their dependents, representing a consideration for a benefit flowing directly to the corporation as an incident of its business, and are allowable deductions from gross income.[107]

In a case in which certain corporations and individuals contributing largely to the taxes of a municipality the financial condition of which would not permit the erection of certain bridges, donated the cost of such bridges, it has been held that such donations do not represent a consideration for a benefit flowing directly to the corporations and individuals as an incident to their business, even though the municipal and industrial life of the city was dependent to the largest possible extent upon the bridges and the entire city was benefited by their erection.[108] Payments to trustees by a cemetery corporation during the taxable year of a certain percentage of the proceeds of sales of cemetery lots set aside for a maintenance fund to be controlled solely by the

[105] A. R. R. 373, T. B. 4-21-1411; Reg. 45, Art. 562. As to Red Cross donations see T. D. 2847. Corporations which had erroneously included as deductions for 1918, contributions to the Red Cross and other recognized war organizations were required within 30 days from August 16, 1921, to file a statement under oath showing the amount of such deductions claimed, the amount of net income as reported and as corrected, and the additional amount of tax due (T. D. 3215, T. B. 36-21-1807).

[106] S. 965, T. B. 2-19-164.

[107] O. D. 110, T. B. 2-19-165.

[108] O. D. 607, T. B. 30-20-1094.

trustees thereof are not deductible from the gross income of the corporation even though such payments are required by state law.[109]

MEMBERSHIP FEES AND DUES. Membership fees or dues paid by individuals and corporations to a chamber of commerce or board of trade are deductible as a business expense, provided the membership is employed as a means of advancing the business interests of the individual or corporation.[110] Membership dues paid to a certain lumber exporters' association organized for the purpose of promoting in all lawful ways the general business interests of exporters of forest products by the collection and dissemination to its members of information and statistics relating to such export business, this purpose being accomplished by protecting the lumber export business against unjust discriminations and restrictions, by the establishment of uniform practices, customs, and usages in the trade and by the establishment of an inspection and classification service for the use and protection of members, represent a consideration for benefits flowing directly to the payor as an incident of its business, and consequently, may be deducted as a business expense.[111] Assessments paid by member banks to a clearing house as a means of furthering their business interests may be deducted as business expenses in the returns of such banks.[112]

Payments from Earnings of Public Utility Paid to State. In the case of a public utility acquired, constructed, operated or maintained by a taxpayer under contract with any state, territory, or political subdivision thereof, or with the District of Columbia, containing an agreement that a portion of the net earnings of such public utility shall be paid to the state, territory, or political subdivision thereof, or the District of Columbia, the amount so paid may be deducted by the taxpayer as a necessary expense in transacting business.[113]

[109] O. D. 529, T. B. 22-20-975.

[110] O. D. 421, T. B. 13-20-808.

[111] O. D. 496, T. B. 19-20-916.

[112] O. D. 747, T. B. 50-20-1342.

[113] Revenue Act of 1921, § 213 (b) (7); Revenue Act of 1918, § 213 (b) (7); Reg. 45, Art. 84; T. D. 2090; see Revenue Act of 1916, § 11 (b).

CHAPTER 23

DEDUCTION OF INTEREST

The Revenue Act of 1918 provided that citizens and residents and domestic corporations might deduct all interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which was wholly exempt from taxation as income to the taxpayer. Nonresident aliens and foreign corporations might deduct that proportion of such interest which the amount of his or its gross income from sources within the United States bore to the amount of his or its gross income from all sources within and without the United States.[1] The general provision of the 1921 Law permitting the deduction of interest is the same as that of the 1918 Law except that there is added to the parenthetical exception the words "and originally subscribed for by the taxpayer".[2] In the case of nonresident aliens and foreign corporations the deduction of interest is allowed only if and to the extent that it is connected with income from sources within the United States and the proper apportionment and allocation with respect to sources of income within and without the United States must be determined in accordance with the statute and under rules and regulations prescribed by the Commissioner with the approval of the secretary.[3] But this deduction, under both laws, is allowed to a nonresident alien only if he files a true and accurate return of his total income from all sources, corporate or otherwise, in the manner prescribed[4] by the law. In all cases, interest upon indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from the income tax to the taxpayer, may not be deducted. Thus, a citizen or resident may, with the exception above stated, deduct all interest paid or accrued within the taxable year on his indebtedness. This

[1] Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2; Reg. 45, Art. 121. The limitations imposed by the 1916 law upon the amount of interest which might be deducted by corporations is discussed in Chapter 10. See also appendix to the 1920 edition of this book.

[2] Revenue Act of 1921, §§ 214 (a) 2 and 234 (a) 2.

[3] Revenue Act of 1921, §§ 214 (b) and 234 (b). See Chapter 4.

[4] Revenue Act of 1918, § 217; Revenue Act of 1921, § 217 (g).

includes not only indebtedness incurred for business purposes, but indebtedness incurred for any purpose, such as for the purpose of buying dwelling houses or any articles or things of personal use. It is immaterial what term is applied to payments on the obligations of a corporation if such payments are in fact interest.[5]

Interest on Capital. Interest calculated as being a charge against income on account of capital or surplus invested in the business, but which does not represent a payment on an interest-bearing obligation, is not an allowable deduction from gross income; that is to say, the interest which the money might earn if otherwise invested is not a deductible charge against income.[6]

Indebtedness Incurred or Continued to Purchase or Carry Tax-Exempt Securities. The Revenue Act of 1921 does not permit the deduction of interest paid or accrued on "indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), and originally subscribed for by the taxpayer,[7] the interest upon which is wholly exempt from taxation under this title."[8] State and municipal bonds are obligations or securities falling within this class, as well as national bonds issued prior to September 1, 1917. Interest on indebtedness incurred for the purchase of Liberty bonds of the second issue (the interest on which is not entirely exempt from the surtax) was held deductible regardless of the limitation contained in the 1917 Law.[9] By the parenthetical clause of the 1918 provision taking obligations of the United States issued after September 24, 1917, out of the exception to the deductibility of interest, the Revenue Act of 1918 made it clear that interest on indebtedness incurred or

[5] O. D. 1060, T. B. 41-21-1861.

[6] Reg. 45, Art. 122.

[7] The words "and originally subscribed for by the taxpayer", were not contained in the 1918 Law. Revenue Act of 1921, §§ 214 (a) 2, and 234 (a) 2.

[8] Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2. Prior to its amendment by the Revenue Act of 1917, it was held under the 1916 Law that interest paid on indebtedness might be deducted, whether or not the indebtedness was incurred for the purchase of bonds, the interest upon which was exempt from taxation. This ruling in effect permitted a double deduction, that is, the interest on the money so borrowed could be deducted and the income derived from the money so borrowed and invested could also be deducted. The 1917 Law did not permit the deduction of interest paid on "indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title." (Revenue Act of 1916, §§ 5 (a), 12 (a), as amended by the Revenue Act of 1917.)

[9] Reg. 45, Art. 121; T. D. 2511.

continued to purchase or carry Liberty bonds of the second and subsequent loans would be allowed as a deduction.[10] The extension of the exception to the deductibility of interest first contained in the 1918 Law and continued in the present law to indebtedness "continued" as well as "incurred," and incurred or continued to "carry" as well as to "purchase" tax-exempt securities should be noted. The limitation imposed by the 1921 Law on the deduction of interest on indebtedness incurred or continued to purchase or carry obligations of the United States issued after September 24, 1917, by the addition of the words "and originally subscribed for by the taxpayer," will have far-reaching effects, as there are probably few taxpayers who are still paying interest on their original subscriptions to such bonds.

Interest Paid or Accrued Within the Year. The 1909 Law provided for the deduction of "interest actually paid within the year" and it was contended by the treasury department that this provision required that the interest should be both accrued and paid within the same year. It was held, however, that interest actually paid within the year although previously accruing should be permitted as a deduction.[11] The 1913 Law provided for the deduction of interest paid within the year by individuals, and "interest accrued and paid within the year" by corporations. In a ruling under that law it was held that in the case of corpora-

[10] Reg. 45, Art. 121; O. D. 40, T. B. 1-19-57. The provision of the 1918 Law permitting the deduction of *all* interest paid or accrued within the taxable year was the subject of some criticism on the ground that it permitted a reduction of the income tax by the purchase of non-taxable securities with borrowed money. The remedy proposed was that the interest deduction be limited to an amount bearing the same proportion to the total interest paid upon indebtedness which the taxpayer's income derived from taxable sources bore to his income from all sources. The provision of the 1918 Law as it stood permitted the deduction of *interest paid or accrued on indebtedness incurred or continued to purchase or carry obligations of the United States issued after September 24, 1917*. The parenthetical exception to the general restriction upon the deduction of interest was designed to stimulate the sale of Liberty Bonds. It will be remembered that the Victory or Fifth Liberty Loan consisted of two kinds of notes; that is, (1) 4¾% three/four year convertible gold notes exempt from state and local taxes except estate and inheritance taxes and from *normal* Federal taxes, (2) 3¾% three/four year convertible gold notes exempt from *all* Federal, state and local taxes except estate and inheritance taxes. It could hardly have been contemplated at the time §§ 214 (a) 2 and 234 (a) 2 (a) of the Revenue Act of 1918 were drawn that the Victory Loan would include any wholly exempt notes or bonds.

[11] Anderson v. 42 Broadway Co., 213 Fed. 777. The Supreme Court in reversing the lower court (239 U. S. 69) did not pass on the question of deducting interest accrued in one year and paid in another.

tions the deduction should be limited to interest which had both accrued and been paid within the same year.[12] The 1916 Law permitted the deduction of interest "paid within the year."[13] The Revenue Act of 1921, like the 1918 Law, permits the deduction of interest "paid *or* accrued within the taxable year."[14] It does not seem essential under these provisions that interest should have accrued or become payable in the year in which it is paid in the case of taxpayers reporting on a basis of cash receipts and disbursements.

Where a decree was made by a lower court in 1917 requiring a corporation to distribute dividends, the decision being affirmed in 1919 and a decree entered requiring payment of interest from the date of the decree in the lower court, the dividend, with interest, being paid in 1919 in accordance with the decree, it has been ruled that the total amount paid should not be treated as a dividend, but only the amount originally decreed by the lower court. This decree established the relationship of debtor and creditor between the corporation and its shareholders, and the final decree not merely affirmed the relationship, but awarded interest on the amount of the debt. The fact that the interest on the debt ran from the date of the decree in the lower court to the date of payment in 1919 does not require an application of the principle of accrual with reference to payment or receipt of interest, as it was not known that interest would be awarded or what the rate of interest would be until the appellate court entered its decree. The interest on the amount of the dividends paid in 1919 in accordance with the decree of the Supreme Court, represented interest paid by the corporation, and was deductible for the year in which paid.[15]

Where a lumber company entered into a contract for the purchase of a timber tract, agreeing to pay for the quantity of timber which it was estimated would be cut each year, payment to be made at the time each block is cut at a certain rate per

[12] T. D. 1960.

[13] Revenue Act of 1916, §§ 5 (a), 12 (a), as amended by the Revenue Act of 1917.

[14] Revenue Act of 1921, §§ 214 (a) 2 and 234 (a) 2; Revenue Act of 1918, §§ 214 (a), 2, 234 (a) 2. The term "paid or accrued" is to be construed according to the method of accounting upon the basis of which the net income of the taxpayer is computed. (Revenue Act of 1921, § 200; Revenue Act of 1918, § 200.) Under the 1916 Law, corporations keeping books of account on an accrual basis were permitted to deduct interest for the year whether paid or not, when such interest was shown as a charge against accrued income upon the books of account (T. D. 2625).

[15] O. D. 778, T. B. 4-21-1407.

thousand feet, plus interest at 6% per annum from the date of contract, it has been held that inasmuch as the interest charge did not accrue and become payable until the timber was cut, it was not a proper deduction until that time. The agreement was an executory contract to purchase the timber and no interest is deductible except as the contract is executed. The interest payment does not constitute an operating expense of the company, but enters into the cost of the lumber produced that year.[16]

Interest on Taxes. Interest paid or accrued on overdue federal income and excess-profits taxes is held not to be a part of the tax but is deductible as interest.[17]

Maryland and Pennsylvania Ground Rent. Payments made for Maryland or Pennsylvania ground rents are not deductible as interest.[18]

Interest on Real Estate Mortgage. Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness.[19]

[16] O. D. 595, T. B. 29-20-1075.

[17] This applies to all interest added to the tax under the provisions of § 250 of the Revenue Act of 1918 and § 250 of the Revenue Act of 1921. O. 922, T. B. 7-20-745; O. D. 319, T. B. 26-19-595.

[18] Reg. 45, Art. 121.

[19] Reg. 45, Art. 121.

CHAPTER 24

DEDUCTION OF TAXES

The provisions of the Revenue Act of 1921, with respect to the deduction of taxes in the case of citizens and residents and domestic corporations are, in general, and with one exception as to taxes paid by corporations for their shareholders, the same as those of the 1918 Law. The 1918 Law specified the taxes which might be deducted; the Revenue Act of 1921 provides for the deduction of all taxes except those specified as not deductible. The provisions of the 1918 Law respecting the deduction of taxes by nonresident aliens and foreign corporations are given below. The Revenue Act of 1921 provides that such taxpayers may be allowed the deduction for taxes granted to citizens and residents and domestic corporations if and to the extent such deduction is connected with income from sources within the United States and the proper apportionment and allocation of such deduction must be determined in accordance with the definitions of income from sources within and sources without the United States set forth in the law and under rules and regulations prescribed by the Commissioner with the approval of the secretary.[1]

In the case of citizens and residents and domestic corporations the provisions of the Revenue Act of 1918 for the deduction of taxes were the same. Such taxpayers might deduct taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits, and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit against the tax of the taxpayer; or (c) by the authority of any state or territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) by the authority of any foreign country except the amount of income, war-profits and excess-profits taxes allowed as a credit against the tax of the taxpayer. Nonresident aliens and foreign corporations were allowed to deduct the taxes included in items (a), (b), and (c) above; in lieu of the taxes included in item (d) above they were allowed to deduct taxes imposed by the authority of any foreign country (except income, war-profits and excess-profits taxes,

[1] Revenue Act of 1921, §§ 214 (b) and 234 (b).

and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business.[2] The Revenue Act of 1921 allows the deduction, in the case of citizens and residents and domestic corporations, of taxes paid or accrued within the taxable year except (a) income, war-profits and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit against the tax of the taxpayer, (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed. A citizen or resident may not deduct taxes imposed upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer, the deduction of such taxes now being expressly allowed to the corporation.[3] The provisions of the 1921 Law as to nonresident aliens and foreign corporations have been indicated above. The deduction of taxes by nonresident aliens under both laws is only allowed if they file a true and accurate return of income from all sources, corporate or otherwise, in the United States in the manner prescribed by law.[4] In addition to the taxes which are allowed as a deduction from gross income in computing net income, certain taxes are permitted to be credited against the tax otherwise payable. These credits are discussed in a chapter following.[5]

Taxes Paid or Accrued Within the Year. Under the 1913 and 1916 Laws the provisions permitting the deduction of taxes expressly limited such deduction to taxes *paid* within the year. It was held by the treasury department that reserves for taxes could not be established, as only sums actually paid within the year could be deducted, that is, the aggregate of the amounts actually paid as shown by the cash book.[6] The Revenue Act of

[2] Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3. Reg. 45, Art. 131. Under the 1916 Law, in the case of nonresident aliens and foreign corporations the taxes which might be deducted were limited to those assessed by the United States or its territories or possessions or under the authority of any state, county, school district or municipality or other taxing subdivision of any state, paid within the United States, within the year, except such taxes as were not deductible by any class of taxpayers. (Revenue Act of 1916, §§ 6 (a), 12 (b).) For the special rulings applicable to nonresident aliens and foreign corporations see Chapters 4 and 10.

[3] Revenue Act of 1921, §§ 214 (a) 3 and 234 (a) 3.

[4] Revenue Act of 1921, § 217; Revenue Act of 1918, § 217.

[5] See Chapter 32.

[6] Reg. 33, Arts. 156, 158.

1921, like the 1918 Law, provides for the deduction of taxes "paid or *accrued*." The term "paid or accrued" is to be construed according to the method of accounting upon the basis of which the net income of the taxpayer is computed.[7] The Revenue Act of 1921 provides that for the purpose of their deduction, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes.[8]

The New York state franchise tax imposed for the privilege of doing business in that state for the fiscal year of the state ending October 31, 1920, is based on 1918 income, but is not due and payable until a later date. A taxpayer making a calendar year return on an accrual basis may deduct two-twelfths of such tax in his return for 1919 and ten-twelfths in his return for 1920.[9] Munitions taxes are properly chargeable against the income of the year in which the munitions are made and sold or otherwise disposed of. When the books of the manufacturer are kept upon an accrual basis the amount of such taxes should be included as a deduction from income, and the liability therefor should appear upon the books of account of the company at the close of the taxable year.[10] It has been ruled that a corporation might not accrue munitions taxes for 1916 and 1917 and deduct as expenses the amount so accrued during each year in its munitions tax return for that year before the final computation of the munitions tax had been made. The munitions tax as finally computed must be deducted in the income tax return for the year in which the tax is accrued, irrespective of the year in which the tax is actually paid.[11] Taxpayers must use either the accrual method or the receipts and disbursements method consistently. A corporation making a return for a fiscal year ending during the calendar year 1917, but prior to October 3, was not entitled to deduct from gross income both

[7] Revenue Act of 1918, § 200. The provision of the 1916 Law allowing individuals and corporations to report on a basis other than that of actual receipts and disbursements, and the rulings by the treasury department thereunder, first seemed to permit, and later required, in the case of individuals or corporations reporting on an accrual basis, the deduction of taxes accrued on their books or the amounts reserved for the payment of taxes, providing such amounts did not exceed the actual liability incurred during the year. (T. D. 2433; L. O. 1059, T. B. 10-21-1503).

[8] Revenue Act of 1921, §§ 214 (a) 3 and 234 (a) 3.

[9] O. D. 371, T. B. 3-20-687. See also O. D. 388, T. B. 5-20-715.

[10] A. R. M. 26, T. B. 5-20-713.

[11] A. R. M. 29, T. B. 9-20-770. It must be assumed that the corporation involved in this ruling reports on an accrual basis.

the federal income tax *paid* prior to January 1, 1917, and the income tax *accrued* on its books of account during the months of the fiscal year falling within the calendar year 1916.[12]

Federal Duties and Excise Taxes. Import or tariff duties paid to the proper customs officers, and business, license, privilege, excise and stamp taxes paid to internal revenue collectors, are deductible under the 1918 and 1921 Laws, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they can not be separately deducted.[13] An individual may claim as a deduction the amount of war tax paid on facilities furnished by public utilities, which includes the tax on railroad and steamship fares and the tax paid on admissions and dues. The war excise taxes imposed on articles sold or leased by the manufacturer, producer, or importer[14] were levied against and paid by the manufacturer, producer or importer and were not deductible by the individual purchaser. The consumption taxes imposed by the Revenue Act of 1918[15] on semi-luxuries sold by dealers were paid by the purchaser and were deductible by him.[16]

Capital Stock Tax. For the purpose of computing other income subject to income and excess-profits taxes, the capital stock tax may be deducted from the gross income for the year for which such taxes accrue, if accounts of the corporate taxpayers are kept on the accrual basis, or may be deducted from gross income for the year in which paid, if accounts are kept on the disbursement basis.[17]

Federal Estate Taxes. The treasury department ruled that federal estate taxes were not deductible in computing net income, but in a recent case[18] the Supreme Court of the United States has reversed the department's ruling. In that case the court took the view that the question of the deductibility of federal estate taxes turns entirely upon the statutory provisions under which the estate tax and the income tax are collected. The provision in the Revenue Act of 1918 for the deduction of "taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits,

[12] S. 1305, T. B. 8-20-754.

[13] Reg. 45, Art. 132; O. D. 137, T. B. 4-19-216.

[14] See Revenue Act of 1918, § 900.

[15] Revenue Act of 1918, § 904.

[16] O. D. 287, T. B. 22-19-535.

[17] Letter from treasury department dated June 7, 1919; I. T. S. 1921, ¶ 1364.

and excess-profits taxes" is explicit and unambiguous. The words of its major clause are comprehensive and include every tax which is charged against the estate by the authority of the United States. The excepting clause specifically enumerates what is to be excepted. Estate taxes were as well known at the time the provision was framed as the ones particularly excepted. The estate tax is called a "tax" by the statute imposing it. It is made a general charge on the gross estate and is to be paid out of it by the administrator or executor substantially as other taxes and charges are paid. The department has also ruled that interest upon an overdue federal estate tax is not deductible.[19] Since this decision is predicated upon the reasoning that since the statute describes the interest as constituting "part of the tax"[20] and therefore it is not possible to make a sound distinction between the tax and interest thereon, it would now seem that the interest upon an overdue federal estate tax may be deducted. The Revenue Act of 1921 provides that, for the purpose of their deduction, estate, inheritance, legacy and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes.[21]

Excise Taxes Paid to Cuban Government. The Republic of Cuba imposes on all corporations operating sugar plantations in Cuba a tax of a certain amount on each bag of sugar produced. This tax is based on production, not on income, and is in the nature of an excise tax. It was held under the 1918 Law that a domestic corporation might deduct from gross income in its return to the United States government the amount of such tax paid to the Cuban government, but might not claim the amount as a credit against the total tax due to the United States.[22]

Taxes Imposed by the Authority of any Foreign Country. The term "foreign country", as used in the law, has been held to mean the composite whole made up of all the subdivisions of a foreign state subject to the same central control. Each of the subdivisions, in this sense, is not a "country" but a part of a "country". The Province of British Columbia, therefore, does not come within the meaning of the term "foreign country". It was held under the 1918 Law that amounts of mineral tax

18 U. S. v. Woodward, 65 L. ed. 728, Ct. D. 15, T. B. 26-21-1706.

19 O. D. 594, T. B. 29-20-1074.

20 Revenue Act of 1918, § 406.

21 Revenue Act of 1921, §§ 214 (a) 3 and 234 (a) 3.

22 O. D. 372, T. B. 3-20-688.

and income tax paid to the province of British Columbia by a domestic corporation are deductible as business expenses.[23]

Depositors' Guaranty Fund. Banking corporations, which pursuant to the laws of the states in which they are doing business are required to set apart, keep and maintain in their banks the amount levied and assessed against them by the state authorities as a "depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund, provided that such fund, when set aside and carried to the credit of the state banking board or duly authorized state officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or state officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the state to the assets of the banking corporation. If, however, such amount is simply set upon the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper state officers.[24]

Automobile License Fees. It has been ruled that automobile license fees are ordinarily taxes and therefore deductible.[25]

Securities Taxes. Amounts paid to states under secured debts laws in order to render securities tax-exempt are deductible.[26]

State Tax on Massachusetts Trust Companies. It has been held that Massachusetts trust companies may deduct the amount of the tax levied by the state on their corporate franchises, the amount of such taxes being based on their capital stock, surplus and undivided profits at the time the assessment is made.[27]

Taxing Subdivisions of Territories. It was provided by the 1916 law that "taxes paid within the year imposed by the authority of the United States (except income and excess-profits taxes) or of its territories, or possessions, or any foreign country, or by the authority of any state, county, school district, or municipality, or other taxing subdivision of any state, not including those assessed against local benefits" were deductible.[28] No express provision was made for the deduction of taxes im-

[23] O. D. 1050, T. B. 39-21-1844.

[24] Reg. 45, Art. 567; T. D. 2152.

[25] Reg. 45, Art. 131.

[26] Reg. 45, Art. 131.

[27] O. D. 1043, T. B. 38-21-1833.

[28] Revenue Act of 1916, §§ 5, 6, 12 (a) and 12 (b), as amended by Revenue Act of 1917.

posed by the authority of "any taxing subdivision" of any territory. The Revenue Act of 1918 provided[29] for the deduction of taxes imposed by a taxing subdivision of any territory. Such taxes may be deducted under the present law since they are not expressly excepted from those taxes which are allowed as a deduction.

Taxes Paid by Vendee for Vendor. If, in pursuance of a contract, a vendee corporation agrees to pay the income and excess-profits taxes, on profits arising out of the sales returned by the vendor corporation on a calendar-year basis, such vendee corporation may, if it reports on an accrual basis for a fiscal year ending in October of the calendar year, submit an amended return in which the extent of the accrual of such taxes in such fiscal year is deducted from gross income. If, however, such contracts are regularly entered into by the vendee corporation as a consistent practice, the vendee corporation should be allowed the deduction as for the year in which the taxes are paid or determined, unless gross distortion of income, as between years, results.[30]

Taxes Paid by a Tenant. Where a tenant pays the taxes on property leased by him, he may consider the amount so paid as an additional payment of rent and may deduct it as an expense of carrying on his business.[31] To the landlord the amount is equivalent to an additional payment of rent and must be reported as such, but he may also deduct the amount, as, to him, it is a tax paid during the year by the tenant as his agent. The transaction is tantamount to a payment of the sum by the tenant to the landlord and a repayment by the landlord to the tenant, as his agent, for the purpose of satisfying the tax.[32] Assessments for local benefits paid by a tenant for his landlord according to agreement are held to be additional rent paid by the tenant, and therefore deductible from his gross income. The amount so received by the landlord is taxable income to him, but because of its nature is not an allowable deduction from his gross income.[33]

Taxes Not Deductible. The Revenue Act of 1921 and the Revenue Act of 1918 expressly provide that no taxpayer shall deduct (a) income, war-profits and excess-profits taxes imposed by the authority of the United States, (b) taxes assessed against

29 Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.
30 A. R. M. 16, T. B. 2-20-669.
31 T. D. 2090.
32 Reg. 45, Art. 109.
33 O. D. 373, T. B. 3-20-689.

local benefits of a kind tending to increase the value of the property assessed, and (c) taxes paid by a corporation pursuant to a so-called "tax-free" covenant contained in its bonds, mortgages, deeds of trust, or other similar obligations; and the 1918 Law provided that nonresident aliens and foreign corporations might not deduct (a) income, war-profits and excess-profits taxes imposed by the authority of any foreign country, and (b) taxes assessed against local benefits of a kind tending to increase the value of the property assessed imposed by the authority of any foreign government.[34] Nonresident aliens and foreign corporations are now allowed the same deduction for taxes as citizens and residents and domestic corporations subject to the limitations stated in the introductory paragraph of this chapter. Although income, war-profits and excess-profits taxes imposed by the authority of any possession of the United States, or any foreign country (in the case of citizens or residents or domestic corporations) are not allowed as a deduction, they are allowed as a credit against tax.[35] The 10% tax imposed by the Revenue Act of 1916 as amended, on the undistributed net income of corporations is considered an income tax and is therefore not deductible.[36] War-profits and excess-profits taxes are allowed as a credit to domestic or foreign corporations against the income tax for the same taxable year.[37] Additions to tax because of a delinquent return may be deducted from gross income and will not be disallowed on the ground that they are part of the income or profits taxes within the provisions of law forbidding the deduction from gross income of such taxes.[38] Taxes paid

[34] Revenue Act of 1921, §§ 214 (a) 3, 234 (a) 3; Revenue Act of 1918, §§ 214 (a) 3 and 234 (a) 3.

[35] Revenue Act of 1921, §§ 222 and 238; Revenue Act of 1918, §§ 222, 238.

[36] Letter from treasury department dated April 1, 1919; I. T. S. 1919, ¶ 3285.

[37] Prior to its amendment by the Revenue Act of 1917 it was held under the 1916 Law that the income tax paid on income of one year, whether paid by the taxpayer or withheld at the source, was property deductible from the net income of the following year. (T. D. 2135.) The 1917 amendment provided that income and excess-profits taxes paid by the taxpayer should not be allowed as a deduction (Revenue Act of 1916, §§ 5, 6, 12 (a) and 12 (b) as amended by the Revenue Act of 1917), but in assessing the income tax the net income embraced in a return made under the 1917 Law was credited by the Commissioner with the amount of any excess-profits taxes imposed by Act of Congress and assessed for the same calendar or fiscal year upon the taxpayer, and in the case of a member of a partnership, with his proportionate share of such excess-profits taxes imposed upon the partnership. (Revenue Act of 1916, § 29, added by Revenue Act of 1917.)

[38] O. 926, T. B. 23-19-551.

by a corporation for its stockholders have been held by the courts under prior laws not to be deductible, but the present law makes such taxes deductible by the corporation and not by the shareholder.[39] Postage is not a tax and is therefore not deductible.[40]

Taxes Assessed Against Local Benefits. The taxes contemplated by the law as deductible are those which are paid to defray the expense of running the government. Where the taxpayer pays an assessment for something which will directly benefit him or his property it is not considered to be a tax in the true sense, but rather in the nature of an investment in property. The Revenue Act of 1921 and the Revenue Act of 1918 expressly provide that taxes assessed against local benefits "of a kind tending to increase the value of the property assessed" shall not be deductible.[41] It has been ruled that so-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to the property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and when it is clear that the assessments are so limited, the amounts paid thereunder are not deductible as taxes. Taxpayers will be required to show, in their income tax returns, the nature of assessments paid under the Illinois drainage laws, inasmuch as such laws provide both for special assessments for benefits and for general taxation, depending in some instances upon ordinances promulgated by the trustees of drainage districts.[42] When assessments are made for the purpose of maintenance or repair of local benefits, the taxpayer may deduct the assessments paid as an expense in-

39 Revenue Act of 1921, §§ 214 (a) 3 and 234 (a) 3.

40 Reg. 45, Art. 131.

41 Revenue Act of 1918, § 214 (a) 3; Revenue Act of 1921, §§ 214 (a) 3 and 234 (a) 3.

42 O. 928, T. B. 24-19-561.

curred in business, if the payment of such assessments is necessary to the conduct of his business. Where the assessments are made for the purpose of constructing local benefits, the payments by the taxpayer are in the nature of capital expenditures and are not deductible. Where assessments are made for the purpose of both construction and maintenance or repairs, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation can not be made, none of the amounts so paid is deductible.[43]

TAXES PAID UNDER "TAX-FREE" COVENANTS. Where a corporation pays taxes for its bondholders under stipulations in bonds agreeing to pay the interest in full regardless of any tax which it may be required to withhold or deduct, the amount of taxes so paid on behalf of such bondholders is not a proper deduction by the corporation.[44] It was ruled under the 1918 Law that the bondholder might, however, treat the amount so paid for him as his tax and deduct the same, if it was a tax levied by a state; if levied by the federal government he could not deduct the amount as the law expressly prohibited deduction of the federal income-tax. The amount of income-tax paid for a bondholder by an obligor pursuant to a tax-free covenant in its bonds was ruled to be in the nature of additional interest paid the bondholder and was required to be included in his gross income.[45] The Revenue Act of 1921 expressly provides that such taxes shall not be included in the gross income of the obligee.[46]

STATE INHERITANCE TAXES. State inheritance taxes paid by the executor or administrator of an estate of a deceased person, which are provided by law to be deducted from the respective legacies or distributive shares, are not allowable deductions in computing the net income of such estate subject to tax, even though the will contain a direction to pay inheritance taxes out of the residue. An inheritance tax is upon the transfer of the property and not upon the estate of the decedent or upon the executor or administrator, although the latter is required to pay it. In general, taxes paid or accrued within the year imposed by the authority of any state, or otherwise, are limited to those imposed upon the taxpayer and do not include taxes paid by him

[43] Reg. 45, Art. 133, as amended by T. D. 2937. See also T. D. 2090; Reg. 33, Art. 153.

[44] Revenue Act of 1921, § 234 (a) 3; Revenue Act of 1918, § 234 (a) 3. See T. D. 1948. The rulings on this point are contained in Chapter 20.

[45] Reg. 45, Art. 31.

[46] Revenue Act of 1921, § 234 (a) 3.

on behalf of another, even though he is required by law to make such payment. Since, moreover, state inheritance taxes are imposed upon the transfer before the property reaches the legatee or the distributee, and merely diminish the capital share of the estate received by him, such taxes are not imposed upon the legatee or distributee and are not an allowable deduction from his gross income.[47]

Taxes Paid by Corporation for Stockholders Under 1921 Law. The Revenue Act of 1921 provides that taxes imposed upon a taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer, may not be deducted by such shareholder or member, but may be deducted by the corporation.[48] The 1918 Law was silent on this point and the treasury department took the opposite view. The rulings made on this subject under the 1918 Law are given in the following paragraph.

Taxes Paid by Corporation for Stockholders Under 1918 Law. Under the statutes of many of the states taxes are assessed against the stockholders of banks, the bank being required to pay the tax on behalf of its stockholders. Banks paying taxes assessed against their stockholders on account of their ownership of the shares of stock issued by such banks were not permitted, under the 1918 Law, to deduct the amount of taxes so paid. The shares of stock being the property of the stockholders, to the extent that the taxes assessed on the value of the shares of stock are property taxes the holders were considered to be primarily liable for their payment. As federal statutes prohibit states from imposing any tax upon national banks except upon the value of their real estate, in cases where states levy a tax on the stock of such banks and make it the duty of the banks to pay such tax for the stockholders, such payments were held not deductible from the gross income of such

[47] Reg. 45, Art. 134; letter from treasury department dated February 10, 1916; I. T. S. 1918, ¶¶ 486, 796 and 1669; T. D. 2933; Prentiss v. Eisner, 260 Fed. 589, affirmed 267 Fed. 16, decided under the 1913 Law. In this case, speaking of the New York Inheritance Tax, the lower Court said: "The condition of the devolution of the property is the receipt of the transfer tax by the state. * * * I * * * am convinced that the tax cannot properly be regarded as an imposition upon either the property or the right to receive a gross amount of the property of a decedent represented by a legacy, devise or distributive share, but that the property and the right to receive it passed, reduced by the amount of the tax measured by a percentage of the value of the gross share." (T. D. 2933.) See also Op. A. G. 1, T. B. 16-20-875; O. 812, T. B. 13-19-419.

[48] Revenue Act of 1921, §§ 214 (a) 3 and 234 (a) 3.

banks. This rule applied also in the case of corporations other than banks, upon the value of whose stock taxes were assessed to the stockholders.[49] As a general rule the amounts of taxes so paid by a corporation for its stockholders are not collected from the stockholders, the corporation charging the taxes as an item of expense. Such taxes, however, were required to be reported by the stockholders respectively as taxes paid by them, according to their proportionate interests in the corporation.[50] The amount of the taxes so paid were also required to be treated as additional dividends from the net earnings of the corporation.[51] While it has been decided, under the 1909 Law,[52] that taxes paid to a state by various corporations upon shares of their stock owned by another corporation were not deductible from gross income of the latter corporation as taxes "paid by it," such taxes not being paid by this corporation, but in its behalf by other corporations, the practice of the treasury department in this regard was, however, to allow the deduction of such taxes by the corporation in whose behalf they were paid. Under the

[49] Reg. 45, Art. 566. In such cases it was held under the 1909 Law, that the bank was not entitled to deduct the amount of taxes so paid as the tax was not a tax upon the bank or upon its property. (Eliot Nat. Bank v. Gill, 210 Fed. 933; T. D. 1763; but see U. S. v. Guaranty Trust & Savings Bank, 253 Fed. 291.) This rule was continued under the 1913 Law and the 1916 Law, such taxes being held to be against the property of the private stockholders and not against either the corporation or its property. (Northern Trust Company v. McCoach, 215 Fed. 991; T. D. 2135.) The requirements of a State law that a bank shall pay for the stockholder cannot be construed as authority under which the bank may deduct the tax. (T. D. 2161.) Where a statute requires the bank to pay the tax and gives it a lien upon the shares, the bank is not entitled to deduct the tax. (Eliot National Bank v. Gill, 210 Fed. 833, affirmed 218 Fed. 600; National Bank of Commerce v. Allen, 211 Fed. 743, affirmed 223 Fed. 472, petition to the United States Supreme Court for writ of certiorari denied October 25, 1915.) Where the statute gives the bank the option either to pay the tax out of its general funds or to collect the same from its stockholders, that fact does not change the character of the tax as a tax against the property of the individual stockholders, and the bank cannot deduct. (Northern Trust Co. v. McCoach, 215 Fed. 991.) Even though the state statute makes no provision for recovery from the several shareholders of their proportional part of the amount so paid, the bank cannot deduct. (First Nat. Bank v. McNeel, 238 Fed. 559.) The absence of an express provision in the statute does not show that there is no such right of recovery, or that the intention was for the tax to fall ultimately upon the bank and not upon the stockholders. (Home Savings Bank v. Des Moines, 205 U. S. 503.)

[50] Reg. 45, Art. 566; T. D. 2135.

[51] Reg. 45, Art. 566. See Chapter 19.

[52] U. S. v. Aetna Life Ins. Co., 260 Fed. 333; T. D. 2927.

Revenue Act of 1918, amounts received by stockholders of a corporation as dividends from another corporation taxable upon its net income were also allowable deductions.[53] The proper procedure of the corporation in whose behalf the taxes were so paid would seem, therefore, to be to include the taxes in its gross income, to deduct them from gross income as dividends received, and to deduct them as taxes paid.[54]

In accordance with the above general rules, it was held under the 1918 Law that trust companies, building and loan associations and savings banks of Oregon,[55] state banks, savings banks and trust companies of South Dakota,[56] banking institutions of Louisiana,[57] banks of California[58] and Massachusetts,[59] might not deduct the amount of tax assessed against the stockholders thereof upon the value of their shares. The "Classification Tax Law" of Montana[60] levies a tax upon the "moneyed capital" of Montana banks assessable directly against the banks which are primarily liable therefor. It was held that beginning with the year 1919, such banks were entitled to deduct the amount of the tax paid to that state on moneyed capital and that the stockholders of such banks were not required to include the amounts thus paid by the banks in their respective returns nor allowed to deduct such amounts from gross income.[61]

Where shares of stock were sold after the tax had been assessed, but prior to the time it was paid by the corporation on behalf of the stockholders, the one holding the stock on the date when a tax became due and payable was the one entitled to report the amount as a dividend and deduct the amount as a tax paid by him.[62]

Under the provisions of the New York state tax law on or before the 1st day of June each year a bank located in New

53 Revenue Act of 1918, § 234 (a) 6.

54 O. 858, T. B. 7-19-302; O. D. 199, T. B. 9-19-344.

55 O. D. 70, T. B. 1-19-99.

56 A. R. M. 88, T. B. 44-20-1281.

57 O. D. 987, T. B. 31-21-1758.

58 O. D. 976, T. B. 28-21-1729.

59 O. D. 954, T. B. 25-21-1696.

60 Chapter 21, Sess. Laws, 1919.

61 O. D. 787, T. B. 5-21-1420. This ruling was not applicable to the case of national banks with respect to which the Federal statutes prohibit the imposition of a tax by any State except upon the value of real estate.

62 Letter from treasury department dated February 25, 1916; I. T. S. 1918, ¶ 490. An earlier ruling in a letter dated March 2, 1915, held that the stockholder owning the stock at the time the taxes were assessed was the one entitled to the deduction, but the later ruling referred to above seems to indicate the later attitude of the treasury department.

York City is required to furnish the department of taxes and assessments of the city of New York with a statement under oath, of the condition of the bank on the 1st day of May next preceding. On the basis of the report thus filed, a tax is assessed against the shares of the bank's stock. On or before December 15, the department of taxes and assessments is required to make a statement of the bank assessment and the tax and forthwith to mail the same to the bank and to send a certified copy thereof to the receiver of taxes, whose duty it is to collect the tax. The law provides that it is the duty of the bank to collect the tax due upon its shares of stock and to pay the same in the city of New York to the receiver of taxes thereof on or before the 31st day of December. Inasmuch as it appears that May 1 is the date upon which the assessment is deemed to be made, it has been held that stockholders of record as of that date rather than the stockholders of record as of December 31, were entitled to a deduction on account of the tax paid.[63]

Procedure in Case of Banks Improperly Taking Deduction in 1919. Banks which deducted in their returns of income for 1919, taxes assessed against their stockholders on account of their ownership of the shares of stock issued by such banks must file a statement showing the amount of such deductions claimed, the amount of the net income as reported and as corrected, and the amount of additional tax due by reason of the erroneous claiming of the deduction. The total amount of additional tax shown to be due by such statement should be paid at once, together with interest at the rate of 1 per cent a month on the amount of the deficiency of each installment from the original due date. The deduction of these taxes being clearly attributable to negligence on the part of the taxpayer, there should also be added to the additional tax shown to be due in each case the penalty of 5% provided by the statute.[64] In cases where the above procedure is followed amended returns will not be required, and the statements referred to when received will be filed with the original returns in lieu of amended returns.[65]

[63] O. D. 839, T. B. 10-21-1500.
[64] Revenue Act of 1918, § 250 (b).
[65] O. D. 944, T. B. 23-21-1677.

CHAPTER 25

DEDUCTION OF LOSSES

The Revenue Act of 1921, like the Revenue Act of 1918, provides in the case of individuals that in computing net income there may be allowed as deductions, if sustained during the taxable year and not compensated for by insurance or otherwise, (a) losses incurred in trade or business, (b) losses incurred in any transaction entered into for profit, though not connected with the trade or business, (c) losses of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty or from theft.[1] The extent to which losses may be deducted by nonresident aliens, foreign corporations and certain citizens and domestic corporations taxable only on income from sources within the United States is more fully discussed in previous chapters.[2] Individuals and corporations may also deduct debts ascertained to be worthless and charged off within the taxable year.[3] In the case of corporations all losses sustained during the taxable year and not compensated for by insurance or otherwise may be deducted.[4] The rules discussed in this chapter are those applicable to corporations and individuals generally. The Revenue Act of 1918 contained a provision, not previously contained in any prior law, for the deduction of net losses in certain cases from the income of the preceding year,[5] and also a provision as to losses in inventory and from rebates ascertained after the close of the taxable year.[6] The Revenue Act of 1921 contains several new and important provisions in addition to the general provisions stated above as to the deduction of losses. The changes as to such deductions by nonresident aliens and foreign corporations are discussed elsewhere.[7] Under the 1918 Law, losses, to be deductible, were required to be sustained during the year

[1] Revenue Act of 1921, § 214 (a) 4, 5, 6; Revenue Act of 1918, § 214 (a) 4, 5, 6. Reg. 45, Art. 141.

[2] See Chapters 4 and 12.

[3] Revenue Act of 1921, §§ 214 (a) 7 and 234 (a) 5; Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.

[4] Revenue Act of 1921, § 234 (a) 4; Revenue Act of 1918, § 234 (a) 4. Losses sustained by a corporation in ultra vires transactions are not deductible. (O. 968, T. B. 1-20-660).

[5] Revenue Act of 1918, § 204.

[6] Revenue Act of 1918, §§ 214 (a) 12 and 234 (a) 14.

[7] See Chapters 4 and 12.

in which the deduction was taken. The present law provides that losses shall be deducted as of the taxable year in which sustained, unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period. Reasonable additions to reserves for bad debts may now, in the discretion of the Commissioner, be deducted, and when satisfied that a debt is recoverable in part, the Commissioner may allow such debt to be charged off in part. It is also specifically provided by the present law that the deduction for loss in the case of property destroyed or damaged shall be computed on the basis of the fair market price or value of the property as of March 1, 1913, if such property was acquired prior thereto. No deduction for loss is allowed under the present law in the case of the sale or other disposition of stock or securities where substantially identical property is acquired within 30 days before or after such sale or other disposition. The net loss provision of the 1918 Law is extended to all taxable years beginning after December 31, 1920, and the special deduction allowed by the 1918 Law in regard to losses in inventory and from rebates is, of course, not carried into the 1921 Law.[8] The 1921 Law also provides a different basis for determining loss from the sale or other disposition of property acquired by gift after December 31, 1920.[9]

Losses Sustained in Trade. Under the present and preceding laws losses sustained during the taxable year and not compensated for by insurance or otherwise, may be deducted, in the case of individuals, if incurred in trade or business.[10] All losses may be deducted by corporations. A loss incurred in trade or business must be absolute and not a speculative or fluctuating valuation of a continuing investment, and must be determined and ascertained to be an actual, a completed, a closed transaction.[11] Thus, a loss may be claimed by the owner of a business truck demolished in collision with a pleasure car provided that the truck was in use in connection with the business of the taxpayer at the time of the collision, but no deduction may be claimed by the owner of the pleasure car wrecked in the collision.[12] If an automobile is purchased with the intention of using it in a business and it is appropriated to business uses pri-

[8] Revenue Act of 1921, §§ 204 (b), 214 (a) 4, 5, 6, 7, and 234 (a) 4, 5.

[9] Revenue Act of 1921, § 202 (a) 2.

[10] Revenue Act of 1921, § 214 (a) 4; Revenue Act of 1918, § 214 (a) 4; Reg. 45, Art. 141.

[11] Reg. 45, Art. 141; T. D. 1989. Depreciation in the value of property is treated as a separate deduction and should not be confused with loss.

[12] O. D. 857, T. B. 13-21-1351.

marily, a loss sustained through its sale may be deducted, notwithstanding its occasional use for pleasure purposes.[13]

Losses Not Sustained in Trade. Under the present law and under the 1918 Law citizens and residents may deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business.[14] It will be noted that in this provision the 1918 Law made an important departure from the 1916 Law and there is now permitted the deduction of all losses incurred in transactions entered into for profit though not connected with a trade or business, notwithstanding that such losses may exceed the profits arising from the same class of transactions. The provision permitting the deduction of losses incurred "in any transaction entered into for profit" does not contemplate that a distinction shall be made between an investment in property or securities with the object of deriving an income from the capital employed, and an investment which is made for the purpose of realizing a profit on the resale of the property or securities purchased.[15] Returns realized from either the ownership or the final disposition of investments, representing transactions entered into for profit, but not connected with the taxpayer's business or trade, are "profits" within the meaning of the law.[16]

Where a person purchases bonds for another, guaranteeing said bonds against any loss, and a loss occurs due to subsequent

[13] O. D. 943, T. B. 23-21-1676.

[14] Revenue Act of 1921, § 214 (a) 5; Revenue Act of 1918, § 214 (a) 5. Under the 1916 Law, a citizen was permitted to deduct the losses actually sustained in transactions entered into for profit but not connected with his business or trade only to an amount not exceeding the profits arising therefrom. A loss was required to be actually sustained during the year and the total amount deductible could not exceed the profits arising from the same class of transactions. (Revenue Act of 1916, § 5.) Thus, an individual making any investments in property from time to time or speculating was required to report all gains from such investments or speculations and might offset against the gains all losses sustained in similar transactions. He was required to report only the net gain from such transactions during the year, and if the net result for the year of a series of such transactions was a loss, he was not entitled to offset the loss against his income from trade or business. Prior to the 1916 Law it was held by the Treasury Department that an individual was required to report all income from transactions not incurred in trade, but was not entitled to deduct any of the losses. (T. D. 2135.) See also L. O. 1061, T. B. 14-21-1547.

[15] O. D. 138, T. B. 4-19-218.

[16] L. O. 1061, T. B. 14-21-1547, decided under the 1916 Law.

insolvency of the corporation issuing same, and the guarantor makes good the loss, the same is not deductible unless such loss occurs in trade or business or in a transaction entered into for profit.[17] Where borrowed money is stolen from the borrower and the amount has been borrowed for use in a business deal, the borrower may deduct the amount borrowed with interest paid thereon as a loss, but any amounts expended in apprehending the thief are regarded as a personal expense.[18] The department has allowed as a deductible loss an amount paid by a taxpayer to compromise a suit growing out of his actions while serving as a director of a bank, on the theory that if acting as director he was not engaging in trade or business; it was at least a transaction entered into for profit.[19]

Losses Connected With Residential Property. Where a taxpayer sells his residence at a loss because of the acceptance of a business proposition necessitating his removal to another part of the country, the loss is not a loss "incurred in his business or trade" within the meaning of the Revenue Act of 1916, as amended.[20] A loss sustained by an individual from the sale of residential property was held to be deductible under the Revenue Act of 1918, which is similar in its provisions in this connection to the present law, if the property was purchased or constructed by him with a view to its subsequent sale for pecuniary profit. The intent in purchasing or constructing the property is a question of fact determinable in each case by evidence which should be submitted with the return. If the residential property be held by the purchaser out of use or under tenancy and be subsequently sold, there would seem little room for question that the transaction was "entered into for profit" and that the loss, if any, is a proper deduction in determining net income. If, on the other hand, the property is occupied by the purchaser as his home during the whole or a great portion of the period of his ownership, a strong presumption is raised that the property was purchased for his personal use as a residence; that the transaction was not "entered into for profit" within the meaning of the statute. This presumption will not be overcome by his self-serving declaration, uncorroborated, that his purpose was otherwise.

An individual claiming deduction for loss incurred in the sale of residential property should attach to his return an affidavit

[17] O. D. 241, T. B. 13-19-420.

[18] O. D. 571, T. B. 27-20-1040.

[19] O. D. 1091, T. B. 45-21-1908.

[20] A. R. R. 96, T. B. 19-20-918. The ruling of the Treasury Department was similar under the 1918 Law. (Reg. 45, Art. 141; T. D. 2972).

stating the facts as to the purpose and use of the property in connection with which loss is claimed and his intent in purchasing it, and his affidavit should be supported by other evidence showing his intent when he entered into the transaction.[21]

The subletting of an apartment by a tenant on account of being required to make his residence in another city, is held not to be a "transaction entered into for profit." Therefore, any loss sustained through such transaction is not deductible from gross income.[22]

LOSSES FROM SALE OF PROPERTY ACQUIRED BY GIFT, BEQUEST, DEVISE OR DESCENT. A loss sustained from the sale of property acquired by gift, bequest, devise, or descent (whenever property so acquired is as a matter of fact acquired for purposes of profit) is a deductible loss from gross income. Ordinary investment property so acquired is to be treated as having been acquired for purposes of profit unless the conduct of the recipient furnishes evidence to the contrary.[23] Where a person gives property away or is divested thereof by death, no realization of loss results therefrom.[24] In general, the measure of loss from sales of such property is determined in accordance with the rules for determining gain or loss from sales stated elsewhere.[25] The cost of such property is its value as of the date when acquired. In the case of property acquired by gift after December 31, 1920, however, the basis for determining loss will be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift.[26]

Trade or Business. Under the 1916 Law, the term "trade" and the term "business" were defined as synonymous terms and to be, "That which occupies and engages the time, attention and labor of any one for the purpose of livelihood, profit, or improvement; that which is his personal concern or interest; employment, regular occupation, but it is not necessary that it should be his sole occupation or employment." The doing of a single act incidentally or of necessity not pertaining to the particular business of the person doing the same will not be considered engaging in or

21 Reg. 45, Art. 141, as amended by T. D. 2972; O. 780, T. B. 1-19-51; A. R. R. 249, T. B. 35-20-1168, modified by A. R. R. 604, T. B. 32-21-1760.

22 O. D. 42, T. B. 1-19-59.

23 T. B. R. 34, T. B. 10-19-357.

24 T. D. 2972, amending Reg. 45, Art. 141.

25 See Chapter 17.

26 Revenue Act of 1921, § 202 (a) 2. See Chapter 17 for a discussion of this subject. See also paragraphs in this chapter on "Measure of Loss" and "Property acquired by gift under 1918 Law".

carrying on business.[27] "In trade," as used in the 1916 Law, is held to mean the trade or trades in which the person making the return is engaged; that is, in which he has invested money, otherwise than for the purpose of being employed in isolated transactions, and to which he devotes at least a part of his time and attention. A person may be engaged in more than one trade and may deduct losses incurred in all of them under this provision of the law, provided that in each trade the above requirements are met.[28] Losses on stocks, grain, cotton, etc., may also be deducted under this provision by a person engaged in the trade to which buying or selling thereof are incident as a part of the business, as by a member of a stock, grain or cotton exchange,[29] but neither the investment of money in the stock of a company nor employment by the company in any official capacity makes the business of the company the trade of the investor or employee.[30]

[27] T. D. 1989.

[28] Black v. Bolen, 268 Fed. 427; T. D. 2090.

[29] T. D. 2090.

[30] T. D. 2135. The definition of "trade or business" discussed in the text above has now lost considerable importance in view of the provision (Revenue Act of 1921, § 214 (a) 5; Revenue Act of 1918, § 214 (a) 5) that losses incurred in any transaction entered into for profit may be deducted even though such losses exceed the profits arising from the same class of transactions. Under the 1916 Law, it will be noted, the Treasury Department adopted an extremely narrow construction of the words "business or trade," a construction which has been the subject of considerable criticism and which operated to the detriment of every person investing or speculating in property. Congress has now seen fit to remedy the injustice involved in this narrow construction by permitting the deduction of all losses in transactions entered into for profit even though they may exceed the profits arising from the same transactions. Consequently the definitions of "trade or business" discussed in the text above are no longer so important except in cases arising under the 1916 and 1913 Laws. In Bryce v. Keith, 257 Fed. 133, arising under the 1913 Law, the Court has adopted a broader construction of the term "trade" than the Treasury Department. In this case it was held that loss of the value of corporate stock, acquired by numerous transfers of property to the corporation and payment of corporate debts, transactions carried on for a considerable period, complicated in character and involving large sums of money so that they must have required much time and attention, was a loss incurred in trade.

In Mente v. Eisner, 266 Fed. 161, arising under the 1913 Law, the majority opinion approved the Treasury Department's rather narrow construction of the word "trade". In this case the plaintiff whose regular business was *manufacturing* jute bags and bagging, cotton bags, etc., suffered losses in dealing in futures on the Cotton Exchange and was not permitted to deduct such losses on the theory that they were isolated transactions outside the regular business of the taxpayer. Manton, J., dissents in a long opinion on the general ground that the statute contained

The losses which were limited by this provision of the 1916 Law were those incurred in transactions involving sales or dealings in property. The law seemed clearly to make a distinction between such losses and losses arising from fires, storms, shipwreck, or other casualty, and from theft.

Losses Must Be Sustained During Year. The 1916 Law provided in the case of individuals that the loss must be "actually sustained during the year" and in the case of corporations that the loss must be "actually sustained and charged off within the year."[31] The Revenue Acts of 1918 and 1921 omit the word "actually" in the case of individuals and the words "actually" and "and charged off" in the case of corporations. The treasury department held, under the 1918 Law, that a loss to be deductible must be an absolute loss, actually sustained and ascertained during the taxable year for which the deduction is sought to be made. It must be determined and ascertained upon an actual, a completed, a closed transaction. Losses sustained from the sale or dealing in real or personal property growing out of the ownership or use of, or interest in, such property will not be deductible at all unless they are ascertained, determined and fixed as absolute in the above sense within the taxable year in which the deduction is sought to be made.[32] The amount to be deducted as a loss should have in it no element of "depreciation" or "allowance for wear or tear" or "compensation from insurance or otherwise." The amount is to be an absolute and complete loss which has been

no distinction between a regular dealer on the Exchange and a person who dealt casually on the Exchange; that though the principal business of plaintiff was bagging, his transactions on the Cotton Exchange were nevertheless "in trade." The plaintiff in this case does not appear to have spent so much time in the Cotton Exchange transactions as did the plaintiff in the Bryce Case (Bryce v. Keith, 257 Fed. 133) in the transactions involved in that case. In a case coming before the Department under the 1916 Law, as amended, an attorney invested in stock of a corporation. Certain of his clients hearing of the attorney's investment made similar investments and the attorney in order to protect his clients, as well as to save his practice from injury, contracted expenses in investigating the condition of the corporation, made advances to the corporation and took an active part in its management. The entire transaction resulted in a loss to the attorney, but it was held that the transaction was a purely commercial one, in no sense professional and not connected with his business or trade and therefore not deductible. (A. R. R. 398, T. B. 8-21-1464). See also A. R. R. 242, T. B. 33-20-1131; A. R. R. 249, T. B. 35-20-1168, modified by A. R. R. 604, T. B. 32-21-1760 and A. R. R. 404, T. B. 10-21-1495.

[31] Revenue Act of 1916, § 12 (a).

[32] Reg. 45, Art. 141; T. D. 2005. See, however, the special rules at the end of this chapter.

actually sustained.[33] The above general principles that losses to be deductible must be actually sustained and determined and ascertained upon completed transactions will still be applicable under the present law, but there is now allowed more latitude as to the year in which they may be deducted. The general rule is still that losses must be deducted in the year in which sustained, but they may now be deducted in a year other than that in which sustained if, in the opinion of the Commissioner, the deduction thereof in such other taxable period will more clearly reflect the income.[34] In explanation of this new provision it is stated in the report of the finance committee of the senate that "losses occurring in one year are frequently not determined or sustained until another year, depending upon court decision or the clearing up of uncertainty. To permit more elastic treatment of such losses, in the interests of justice to the taxpayer, it is provided that certain losses shall not be deducted as of the taxable year in which sustained, if in the opinion of the Commissioner they should be accounted for as of a different period."[35]

The following ruling has been made under the 1921 Law: An embezzlement or a shipwreck may occur in 1921 but not become known until 1922 and in such a case income may be more clearly reflected by accounting for the loss as of 1922 rather than of 1921. If a taxpayer desires to account for a loss as of a period other than the one in which actually sustained, he must attach to his return a statement setting forth his request for consideration of the case by the Commissioner, together with a complete statement of the facts upon which he relies. However, in his income tax return he may deduct the loss only for the taxable

[33] T. D. 2005. Under the 1916 Law, in the case of corporations, the loss might not be deducted unless it was actually sustained during the year and charged off on the books. It was held that a corporation was not entitled to a deduction for a loss unless charged off on the books of the corporation before such deduction was allowed. The statute was not to be construed as requiring that losses be charged off within the taxable year. It was sufficient that they were charged off before they were allowed as deductions. Consequently at the time of an examination of a corporation it was given an opportunity to reopen its books and charge off losses which it had actually sustained during the taxable year. (A. R. R. 377, T. B. 5-21-1415; Letter from treasury department dated June 25, 1918; I. T. S. 1918, ¶ 3599.) This rule seemed to apply with equal force in the case of an individual who kept books, but one who did not keep books was not thereby deprived by the law of the right to claim a loss, except in the case of worthless debts.

[34] Revenue Act of 1921, §§ 214 (a) 6 and 234 (a) 4.

[35] Report of Committee on Finance to accompany the Revenue Bill of 1921, p. 14; T. D. 3261.

year in which actually sustained. Upon the audit of the return the Commissioner will decide whether the case is within the exception provided by the statute; if not within the exception the loss will be allowed only as of the taxable year in which sustained. The allowance of a deduction for a loss in a year other than the one in which sustained is entirely within the discretion of the Commissioner and he will consider exercising this discretion only in exceptional cases. A shrinkage in the value of the taxpayer's stock in trade, as reflected in his inventory, is not such a loss as is contemplated by the provision of the statute authorizing the Commissioner to allow the deduction of a loss for a taxable year other than the one in which sustained.

The following rulings on this subject were made under the 1918 Law. If a mother is *bona fide* indebted to her son and discharges the obligation by transferring stock to him, any excess of the cost of the stock over the amount of the debt and unpaid interest is a deductible loss. This payment of a valid indebtedness is equivalent to a sale in constituting a closed and completed transaction.[36] Under New York state laws, a safe-deposit company is required to wait two years before opening any safe-deposit box for nonpayment of rent. The fact that no rental is paid during these years and it is impossible of collection was held not to permit the company to take a deduction of an amount equal to the rental value of any deposit box which it by law was prevented from opening, unless the company's books were kept on an accrual basis and such amount had actually been accrued. That a taxpayer might derive greater profits if it were not for restrictions placed upon his activities by federal or state laws has no bearing on his returns for federal income tax purposes.[37] A taxpayer was held to sustain no deductible loss by reason of a drop in the rate of exchange where he had remitted certain sums of cash to his London representative to be used in purchasing raw material and where, at the end of the year, the purchases had not been made and the rate of exchange was lower than at the time the exchange was purchased.[38]

Losses of Capital. What the law contemplates as a deduction is the loss of capital,[39] either by the sale of property or by the

36 O. D. 555, T. B. 25-20-1015.

37 O. D. 486, T. B. 18-20-899.

38 O. D. 940, T. B. 23-21-1672.

39 It is interesting to note that under the Civil War Income Tax Laws, losses of capital were not deductible. (See letter from treasury department dated June 8, 1865, 2 Int. Rev. Rec. 36.)

destruction or disappearance of property. It is, therefore, immaterial in what year the capital was created so long as the loss is sustained in the taxable year. All losses to be deductible, if not sustained in trade or business, must result from transactions entered into for profit,[40] or must be losses of property arising from fires, storms, shipwreck, or other casualty or from theft. It has been held that a distribution of dividends by a corporation, whether from capital or from surplus, is not a deductible loss.[41] The question of whether certain payments may be deducted as losses or treated as capital expenditures is discussed in another chapter.[42]

Losses of Income. Loss of income is not, generally speaking, a proper deduction. If, for instance, a debtor defaults in payment of interest, or a corporation fails to pay a regular dividend, or an employer fails to pay commissions or salaries, the amount of such items may not be deducted from other income during the year, as the income is reduced by the mere fact that such sums are not included. If, however, the taxpayer has reported any such amounts as income for the taxable year, or a preceding year, as might be done in the case of taxpayers reporting on a basis other than that of actual receipts and disbursements, the subsequent failure to collect the amounts so entered on the books may be treated as a loss when it is determined that the amount is not collectible.[43]

Measure of Loss. In the case of the sale of assets the loss will be the difference between the cost thereof less depreciation sustained since acquisition and the price at which sold or disposed of. However, the loss which is deductible in the case where such property was acquired before March 1, 1913, and where its fair market value on that date was less than the cost thereof, is the difference between such value (less depreciation) and the price at which sold or disposed of. No loss is recognized in the case of property sold at less than cost minus depreciation, but for more than its

[40] Under the 1916 Law it seemed that a deductible loss need not necessarily be one connected with the business or trade of an individual, except in the case of losses resulting from sales or dealings in property, in which case it was expressly provided that such losses must be incurred in his trade or business. The Revenue Act of 1918 and the present law seem to intend that losses resulting from such sales or dealings may be deducted not only when connected with his trade or business, but when not so connected, if in transactions entered into for profit.

[41] Van Dyke v. Milwaukee, (Wis.) 150 N. W. 509.

[42] See Chapter 21.

[43] This point is discussed in the paragraph below on worthless debts.

fair market value as of March 1, 1913.[44] When loss is claimed through the destruction of property by fire, flood, or other casualty, the amount deductible will be the difference between the cost of the property and the salvage value thereof, after deducting from such cost the amount, if any, which has been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained. Under the 1918 Law, in the case of such property acquired before March 1, 1913, when the fair market value as of that date was lower than the cost, the deductible loss was the difference between such value and the salvage value thereof after deducting from the value as of March 1, 1913, the amount, if any, which had been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which had not been paid out in making good the depreciation sustained. No loss was recognized where the salvage value was less than the cost but more than the depreciated value of such property as of March 1, 1913. In any event the loss should be reduced by the amount of any insurance or other compensation received.[45] The Revenue Act of 1921 specifically provides that in case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction for loss shall be computed upon the basis of its fair market price or value as of March 1, 1913.[46] In the case of property which should be included in the inventory, the basis for determining loss on the sale or other disposition thereof will be the last inventory value thereof.[47]

In a case arising under the 1909 Law, the court said: "There seems to be no limitation provided in the act as to the amount of deductions to be allowed for losses actually sustained from any source during the year, and whether due to conditions of business, the sale of property, or anything else, and the court must, therefore, assume that the statute contemplated that the full amount of all losses sustained within the year would be allowed."[48]

[44] Revenue Act of 1921, § 202 (b); Reg. 45, Art. 141, as amended by T. D. 3209, T. B. 33-21-1773. See Chapter 17 for criticism of method of measuring loss when March 1, 1913, value is involved.

[45] Reg. 45, Art. 141, as amended by T. D. 3209, T. B. 33-21-1773.

[46] Revenue Act of 1921, §§ 214 (a) 6 and 234 (a) 4.

[47] Revenue Act of 1921, § 202 (a) 1; Revenue Act of 1918, § 202 (a) 2.

[48] Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206. In this case the court required the corporation to report as income all of its profits and permitted it to deduct all of its losses on the sale of property

Property Acquired by Gift Under 1921 Law. The Revenue Act of 1921 provides that in the case of the sale or other disposition of property, real, personal or mixed, acquired by gift after December 31, 1920, the basis for determining loss shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner is required, if possible, to obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis will be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof will be the fair market price or value of such property at the time of such acquisition.[49]

Losses from Sales of Property. The most frequent deductions for losses are claimed as a result of the sale of property. In such cases the loss occurs when the selling price is less than the cost. This is the converse of gain from the sale of property which is discussed in a preceding chapter.[50] The cost of the property is determined in the same manner whether the transaction results in a loss or a gain and the same rules apply with respect to property acquired prior to March 1, 1913. Where a taxpayer inherited an undivided interest in a piece of property and sold his interest to his sisters for an amount less than the value at which it was appraised for inheritance tax, the sale price being approximately one-third less than the price which it was estimated that the property would have brought at a forced sale, it has been held that the difference between the fair market value of the property at the date of acquisition and the selling price (with proper adjustments for depreciation and improvements) does not under the facts in the case represent a loss properly

during the year, regardless of the fact that some of the property was purchased prior to the incidence of the tax, it appearing that the result would be the same as if the gains and losses had been prorated as then required by the treasury department.

49 Revenue Act of 1921, § 202 (a) 2.

50 See Chapter 17.

deductible from gross income, but is rather in the nature of a gift to his sisters.[51]

SALE OF STOCK OR SECURITIES. A corporation sustains no deductible loss from the sale of its own stock.[52] Where a contracting company assigned certificates of indebtedness of a state to a bank, under an agreement with the bank for advancing money to pay the operating expenses of the company, the company also paying the bank a discount on the face of the certificates in addition to the accrued interest on the funds advanced, such discount has been held deductible as a loss on the sale of the securities.[53] Under the 1918 Law it was held that if a taxpayer made actual *bona fide* sale of securities at a loss in 1918, the loss was deductible even though the taxpayer repurchase the securities in the succeeding year at the same price for which they were sold. However, the burden of proof would be on the taxpayer to show that the sale was not fictitious.[54] The danger of loss of revenue to the government inherent in transactions of this kind has now been guarded against in the Revenue Act of 1921 which provides that no deduction will be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after November 23, 1921, where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss will be disallowed.[55] Where no deduction is allowed for a loss or a part thereof under the above provision, that part of the property acquired with relation to which such loss is disallowed will, for the purpose of determining subsequent gain or loss, be treated as taking the place of the property sold or disposed of.[56]

[51] O. D. 847, T. B. 12-21-1516.

[52] Reg. 45, Art. 563, as amended by T. D. 3206, T. B. 33-21-1767.

[53] O. D. 999, T. B. 34-21-1778.

[54] O. D. 373, T. B. 3-20-689.

[55] Revenue Act of 1921, §§ 214 (a) 5 and 234 (a) 4. The question of what will constitute "substantially identical property" has not yet been ruled upon. It would seem that where common stock is sold, and, within the prescribed period, the taxpayer acquires preferred stock or bonds of the same corporation or stock or bonds of another corporation, such property should not be regarded as "substantially identical property."

[56] Revenue Act of 1921, § 202 (d) 3.

Losses from Exchanges of Property. Under the 1918 Law, where property was exchanged for other property, the property received in exchange was treated, for the purpose of determining any loss to the taxpayer, as the equivalent of cash to the amount of its fair market value, if any.[57] If the property received in exchange had no fixed value or definitely ascertainable market value, it would be difficult to determine the amount, if any, of loss in the transaction and it seems that no loss could be claimed by the taxpayer. The Revenue Act of 1921 provides that on an exchange of property, real, personal or mixed, for any other such property, no gain or loss will be recognized unless the property received in exchange has a *readily realizable market value,* but even if the property received in exchange has a readily realizable market value no gain or loss will be recognized (1) when any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use, or (2) when a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (b) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. Where property is exchanged for other property and no gain or loss is recognized as above, the property received will, for the purpose of determining subsequent gain or loss, be treated as taking the place of the property exchanged therefor.[58] The rules for determining loss in the case of exchanges of stock or securities are set forth in the following paragraphs.

Exchange of Stock Under the 1918 Law. The Revenue Act of 1918 [59] provided that "when in connection with the reorganization, merger or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or se-

[57] Revenue Act of 1918, § 202 (b).

[58] Revenue Act of 1921, § 202. See Chapter 17.

[59] Revenue Act of 1918, § 202 (b).

curities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." Where in such an exchange a person received for his stock or securities, new stock or securities of a greater par or face value then a gain was presumed and a method was provided for determining the amount of such gain.[60] No provision was made for determining and allowing the deduction of a loss when the new stock or securities received were of less par or face value than those exchanged. It was expressly stated in the law, as quoted above, that where the new stock or securities received were of no greater par or face value than those exchanged no gain or loss should be deemed to occur from the exchange. Where in a case of merger, stockholders of one corporation exchanged their stock for stock of the corporation resulting from the merger and received a par value less than the par value of the old stock, it was held under the 1916 Law that the transaction constituted a sale for income tax purposes, and that a deduction might be claimed for any loss, measured by the difference between the value of the old stock on March 1, 1913, (or the cost, if purchased subsequent to that date) and the value at which the same stock was given in exchange for stock of the company resulting from the merger.[61]

Exchange of Stock Under the 1921 Law. The Revenue Act of 1921 has departed from the somewhat arbitrary basis for determining losses in such transactions provided by the 1918 Law. It is now provided that no gain or loss will be recognized when in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or

[60] Revenue Act of 1918, § 202 (b).

[61] Letter from treasury department dated March 9, 1917; I. T. S. 1918, ¶ 1305; A. R. R. 435, T. B. 13-21-1528. See Chapter 17. Under the 1916 Law such losses were permitted to be deducted in the case of individuals only to the extent that they did not exceed gains from other similar transactions during the year.

[62] Revenue Act of 1921, § 202 (c) 2.

mere change in identity, form, or place of organization of a corporation, (however effected.)[62] In such cases the stock or securities received in exchange will be treated as taking the place of the stock or securities exchanged therefor for the purpose of determining subsequent gain or loss from their sale or other disposition.[63] However, in the case of an exchange of stock or securities for other stock or securities in a transaction other than those outlined above, a deductible loss may arise if the stock or securities received in exchange have a readily realizable market value.

Dividends Paid in Property. Where in 1917 a corporation declared a cash dividend and distributed in payment thereof certain securities theretofore held in its treasury, it has been held that if the net value of the securities at the date of distribution was less than their cost the taxpayer has sustained a deductible loss, provided that in such distribution the market value of the securities as at the date of the dividend was used. At the date of the dividend the corporation parted with title to these securities and thus closed the transactions in them.[64]

Bonds Purchased Above Par. Where bonds have been purchased above par it seems, under the present law, that no deduction can ordinarily be made for the loss of the amount of the premium until the bonds are either sold in the market before maturity, or until the principal sum is received at the time of maturity. In either case the loss will be the difference between the amount paid and the amount received. Where, however, a taxpayer reports on a basis other than of actual receipts and disbursements it seems that this sum may properly be deducted in proportionate amounts each year as amortization.[65]

Losses from Fires, Storms, Shipwreck and Other Casualty. The law expressly provides, in the case of individuals, that the loss arising from fires, storms, shipwrecks, or other casualty, or theft, may be deducted in the year in which the loss is sustained.[66] Under the present law, but not under the 1918 Law, such losses may be deducted in a year other than the one in which sustained, if in the opinion of the Commissioner, income

[63] Revenue Act of 1921, § 202 (d) 1.

[64] A. R. R. 435, T. B. 13-21-1528.

[65] This was also the case under the 1916 Law. Under the 1909 Law it was held that where bonds were purchased at a rate above par a proportionate amount of the premium might be deducted each year on account of amortization (T. D. 1727). See Van Dyke v. Milwaukee, (Wis.) 150 N. W. 509.

[66] Revenue Act of 1918, § 214 (a) 6.

will be more clearly reflected.[67] This kind of loss is allowed to corporations without specific mention, as with respect to corporations all losses are deductible. In the case of nonresident aliens the law permits the deduction of all such losses of property within the United States.[68] In the case of foreign corporations such deductions are allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of such deductions with respect to sources of income within and without the United States must be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.[69] In all cases the law provides that the deduction may be made only when such losses are not compensated for by insurance or otherwise. The intent seems to be to permit a deduction of the losses to the extent that the taxpayer is not compensated by insurance or otherwise. If he is compensated for part of such loss, he may deduct the part for which he is not so compensated. In claiming a loss due to the destruction of property the salvage value of the property must be considered as a partial compensation to be deducted from or not included in the amount claimed as a deduction. The value of the property at the time of the loss is not intended to be the measure of the loss. The measure of loss will be determined in accordance with the rules set forth in a former paragraph.[70]

The term "other casualty" is held to embrace losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design of the one suffering the loss.[71] A loss sustained through the freezing and bursting of the water pipes in a residence during the absence of the occupant has been held deductible as a loss from "other casualty."[72] The following have been held not deductible as losses from "other casualty": (1) a lost ring, the owner being in doubt as to whether it was stolen;[73] (2) a loss sustained by reason of the damage to a pleasure automobile due to an accident attributable

[67] Revenue Act of 1921, §§ 214 (a) 6 and 234 (a) 4.

[68] Revenue Act of 1921, § 214 (a) 6; Revenue Act of 1918, § 214 (a) 6.

[69] Revenue Act of 1921, § 234 (b); Revenue Act of 1918, § 234 (b).

[70] See paragraph "Measure of Loss", supra.

[71] O. D. 526, T. B. 22-20-969.

[72] O. D. 1076, T. B. 43-21-1885.

[73] O. D. 526, T. B. 22-20-969. Of course if the owner of the ring can establish the fact that it was stolen, the loss will be one arising from "theft".

to the icy condition of the streets;[74] (3) amounts expended in defending a suit for damages alleged to have been caused by the negligent operation of an automobile owned and operated for personal convenience;[75] (4) an amount paid by a taxpayer as damages on account of injuries sustained by reason of the plaintiff's tripping over a wire stretched along the curb in front of the taxpayer's residence.[76]

A taxpayer's personal residence located on a beach was damaged by a storm, which washed away part of the foundation and so undermined the building as to render its destruction certain if it was not immediately removed. In removing the building to a safer location it was further damaged. The damage caused by the direct action of the storm and by the removal to avoid further probable damage is held to have arisen from storm and deductible from gross income as a loss. If the building was moved to prevent further loss from the storm in question, the expense of moving it is also deductible as a loss; but if it was moved to prevent probable losses from future storms, the expense of moving it is regarded as a capital expenditure and should be added to the cost of the building in computing profit in the event of its sale, since the removal to a safer locality presumably increased its value.[77]

Losses Arising from Theft. The following rulings were made under the 1918 Law: A loss incurred by a corporation through the embezzlement of its funds is an allowable deduction from gross income for the year in which the embezzlement occurs;

[74] O. D. 629, T. B. 33-20-1132. This ruling seems a questionable interpretation of the statute. The statute provides for a deduction of losses not connected with the trade or business "if arising from fires, storms, shipwreck, or other casualty or from theft, * * *." It would seem that the words "other casualty" are broad enough to include a loss due to icy condition of streets. The word "casualty" has been defined by the courts as follows: "An accident or casualty, according to common understanding, proceeds from an unknown cause or is an unusual effect of a known cause. Either may be properly said to occur by chance and unexpectedly." (Chicago, St. Louis, etc., R. Co. v. Pullman Co., 139 U. S. 79.) The only justification for the ruling is the limitation of the word "casualty" by reference to the words immediately preceding it (see U. S. v. 1150½ Lbs. of Celluloid, 82 Fed. 627) but this is not a cast iron rule and has been disregarded in the construction of the clause "all other gains and profits derived from any source whatever" contained in the Virginia Income Tax Law (see Commonwealth v. Werth, 116 Va. 604, 82 S. E. 695). This clause is very similar to the omnibus clause used in section 213 (a) of the Revenue Act of 1918 and 213 (a) of the 1921 Law.

[75] A. R. R. 444, T. B. 12-21-1527.

[76] O. D. 779, T. B. 4-21-1409.

[77] O. D. 698, T. B. 43-20-1259.

the time of the discovery of the loss bears no relation to the date it was sustained.[78] A loss incurred by a corporation through the embezzlement of securities held in bailment by it is an allowable deduction from gross income of the year in which demand was made by the bailors for the return of the securities and the replacement made by the company.[79] Where a taxpayer suffered a loss through burglary in 1917 and where after litigation it was decided by the court in 1919 that no insurance could be recovered the loss was held to be deductible in 1917, the year in which it was actually sustained.[80]

The Commissioner has discretion under the present law to permit such deductions to be taken in years other than those in which sustained if such procedure will more clearly reflect income.[81]

Voluntary Destruction of Property. Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements has been held to be deductible from gross income, in a sum representing the difference between the cost of such property demolished or scrapped and an amount measuring a reasonable allowance for the depreciation which the property had undergone prior to its demolition or scrapping; that is to say, the deductible loss is only so much of the original cost, less salvage, as would have remained unextinguished if a reasonable allowance had been charged off for depreciation during each

78 Reg. 45, Art. 111. O. 845, T. B. 6-19-275. See ¶ "Recoveries on Losses," infra.

79 A. R. R. 269, T. B. 40-20-1221. In this case at the time of the embezzlement the amount of the loss to the company could not be determined, for it was controlled by the replacement cost of the securities at the date of demand by the owners. The claims against the company might have been waived by the clients and in that case the company would have sustained no loss. Furthermore, the liability of the company to the clients on account of the loss of the property held in bailment was not certain and might have been contested, the company contending that in a bailment for mutual benefit it is held to the exercise of ordinary care in relation to the subject-matter thereof and is responsible only for ordinary negligence. (New York Cent. R. Co. v. Lockwood, 17 Wall. 357; Bleakley v. New York, 139 Fed. 807; Fairmont Coal Co. v. Jones, etc., Co., 134 Fed. 711; Smith v. British Steamship Co., 123 Fed. 176.) The amount expended by the company was in fact a payment in settlement of a legal liability. The right of action of clients accrued when the demand was made for the return of the securities, and the liability of the company was incurred on that date. (Stevens v. Stevens, 132 Mo. App. 624; Walker v. Bement, 94 N. E. 339; Woods v. Latta, 3 Mont. 9; Brown v. Cook, 9 John. 361.)

80 A. R. R. 542, T. B. 26-21-1705.

81 Revenue Act of 1921, §§ 214 (a) 6 and 234 (a) 4.

year prior to its destruction. When a taxpayer buys real estate, upon which is located a building which he proceeds to raze, with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.[82] A taxpayer sustains no deductible loss in the demolition of 80 per cent of his building for the purpose of reconstruction. The amount expended is an investment of capital and should be considered as a part of the cost of reconstruction.[83]

Where a taxpayer purchased improved real estate adjoining his plant, intending to sell the houses thereon and have them removed but found that owing to fire regulations the houses could not be removed and was obliged to sell them for a very small sum, it has been held that since the property was purchased primarily for the enlargement of the plant and not with the view of selling it for profit, and inasmuch as the fire regulations were existent at the time the property was purchased, the houses in fact were worth only their salvage value when purchased, regardless of what it was thought they were worth. The amount paid for the property, including the buildings, less the salvage value of the buildings, represents the amount actually paid for the land. As the land has not been sold or otherwise disposed of, the gain or loss from the transaction, if any, has not been determined. No deductible loss was sustained from the sale of the buildings.[84]

Loss of Useful Value. When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the cost, or, if acquired prior to March 1, 1913, the cost or fair market price or value as of that date, whichever is lower, of any assets so discarded (less any depreciation sustained) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof

[82] Reg. 45, Art. 142; Reg. 33 Rev., Arts. 155 and 156. See Reg. 33, Art. 127.

[83] O. D. 773, T. B. 2-21-1387.

[84] O. D. 1031, T. B. 37-21-1816.

of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income.[85] Such a loss in useful value may not be based on the book value of assets where this book value represents a writing up of appreciation in their value. The loss in useful value must be based on cost or value as of March 1, 1913.[86]

Where on account of rearranging a lease on property occupied by a corporation a large portion of the furniture and fixtures became useless and were torn out, it has been held that the corporation may deduct the amount of such loss. Such a loss is a loss of useful value and may not be deducted by the taxpayer as depreciation.[87] Where it appears that material error has been made in an estimate of the mineral contents of a mine by reason of the discovery of a rock fault, it has been held that such discovery does not give rise to a deductible loss of useful value. A new estimate may be made and the capital remaining

[85] Reg. 45, Art. 143; as amended by T. D. 3206, T. B. 33-21-1767. Under the Hawaiian Law, which does not make any provision for a deduction to cover obsolescence, it has been held that no deduction may be taken to cover the value of mills, buildings, and a railroad discarded on account of the erection of a larger mill at a different location and the construction of a different railroad connected therewith. This transaction was held not to be deductible either as a loss or an expense and it was also held that the provision that "no deduction shall be made for any amount paid out for new buildings, permanent improvements or betterments made to increase the value of any property or estate," did not imply that deduction might be made for all amounts so paid out which did *not* in fact increase the value of the property. (Haw. Commercial, etc., Co. v. Tax Assessor, 14 Haw. 601, 687.)

[86] A. R. R. 556, T. B. 37-21-1817.

[87] A. R. R. 469, T. B. 16-21-1579.

may be recovered thereafter through depletion in the year or years of continued operation.[88] The department has also denied the claim of an ice company for a loss of useful value of a dam constructed to make a lake from which ice was cut where the company voluntarily abandoned the ice business, but apparently the claim was denied because of the department's belief that the dam still had substantial value and because there was no evidence of a "determinable and determined" loss.[89]

Cost of Drawings, Models and Patterns. Expenditures made for designs, drawings, patterns or models representing work of an experimental nature should be treated as a capital disbursement and not as an expenditure if the designs, drawings, patterns or models prove to be satisfactory and result in the production of salable goods. If, however, they prove to be unsatisfactory and have no asset value, the expenditure may be charged off as a loss incident to running the business and as such deducted from gross income, provided that the taxpayer taking credit for such expenditures in the income tax return makes a full and complete explanation with respect to the same.[90] If designs, drawings, patterns, or models result in the production of goods which prove to be salable for a certain length of time and then become obsolete and can not be sold, the amount expended for such designs, drawings, patterns, or models, less any amounts previously claimed as depreciation with respect to the same or as a return of capital, may when charged off, be included in, and deducted as a loss incident to running the business, provided full and complete information is reported in a manner satisfactory to the Commissioner.[91]

Amounts Paid to Make Up Profits of Another Corporation Under Agreement. Contracts guaranteeing the payment of dividends or interest of one corporation by another are frequently made between corporations having close business relations. Whether or not amounts paid under such contracts or guarantees may be deducted, as a loss or as an expense of doing business, by the paying corporation has not been determined by the courts in this country. In England such payments have been held properly deductible as sums expended for the purpose of trade.[92] If the payment is made under an enforceable contract,

[88] A. R. R. 431, T. B. 12-21-1521.

[89] A. R. R. 498, T. B. 20-21-1639.

[90] Reg. 33 Rev., Arts. 175, 176.

[91] Reg. 33 Rev., Art. 177.

[92] Moore v. Stewarts & Lloyds (1906), 8 Fraser 1129. In this case it was observed that the question was one of fact rather than of law. One company

there seems to be no reason why the amount should not be deducted either as loss or expense. This question would seem under the 1918 Law and the present law to be covered in many cases by the provision for the making of a consolidated return by affiliated corporations.[93]

Shrinkage in Securities and Stocks. A person possessing securities such as stocks and bonds, can not deduct from gross income any amount claimed as a loss on account of the shrinkage in value of such securities through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the securities mature or are disposed of. In the case of banks or other corporations which are subject to supervision by state or federal authorities, and which in obedience to the orders of such supervisory officers charge off as losses amounts representing an alleged shrinkage in the value of property, the amounts so charged off do not constitute allowable deductions. The foregoing applies only to owners and investors, and not to dealers in securities. However, if stock of a corporation becomes worthless, its cost, or, if acquired prior to March 1, 1913, its fair market value as of that date, whichever is lower. may be deducted by the owner in the taxable year in which the stock becomes worthless, provided a satisfactory showing of its worthlessness be made as in the case of bad debts.[94]

It has been held in a recent case[95] under the 1909 Law that an insurance company, the greater portion of whose assets consist of stocks, bonds, and other securities, is entitled to deduct

entered into agreement with another whereby in return for the right to nominate a majority of directors of the second company the first undertook to pay to the second such sums each half year as might be necessary to make up any deficit in the dividends on the latter's preferred shares. The court said, "If the agreement was entered into with a view to profit, as I think it was * * * then the annual charge to the respondent company is in my view a part of their business outlay or expenditure and is not subject to assessment."

[93] See Chapter 10.

[94] Reg. 45, Art. 144, as amended by T. D. 3206, T. B. 33-21-1767; T. D. 2882, T. B. 9-19-341; T. D. 3261; letter from treasury department dated August 14, 1914; I. T. S. 1918, ¶ 1344; N. Y. Life Ins. Co. v. Anderson, 257 Fed. 576. The Act of June 30, 1864, as amended by the Act of July 13, 1866, seems to have permitted the deduction from *earnings* of depreciation in investments in bonds and depreciation in stock in order to arrive at the amount of the taxpayer's *profits*. (Miami, etc., R. R. Co. v. U. S., 108 U. S. 277.)

[95] New York Life Ins. Co. v. Anderson, 263 Fed. 527, reversing 257 Fed. 576. The soundness of this view may be doubted. (See Fink v. Northwestern Mutual Life Ins. Co., U. S. circuit court of appeals, seventh circuit, June, 1920, T. D. 3057, T. B. 36-20-1187. See the limiting definition of depreciation in Von Baumbach v. Sargent Land Co., 242 U. S. 503.

the amount of the market depreciation of such securities during the year. The court said in part: "It is here admitted that judged by any standard familiar to business men, the securities of plaintiff were worth at the end of 1910 several million dollars less than they were at the beginning of that year. It is further admitted that, not only was it the business custom of plaintiff to revalue its securities in accordance with the market annually, but that such procedure was and is a reasonable business conservatism, and a frequent, though not universal, statutory requirement. Under this taxing act the question is not strictly whether depreciation in market value is a loss, but whether, when Congress specifically includes within 'losses actually sustained within the year, * * * a reasonable allowance for depreciation of property,' depreciation does not become a loss, no matter what persons other than Congress may think on the subject. We have no doubt that this loss in market value is depreciation. The word means, by derivation and common usage, a 'fall in value; reduction of worth'; and it seems to us to require mention only to prove that the average citizen, for whom statutes are assumed to be made, would judge depreciation of his own bonds by the opinion of the public, however thoroughly convinced of the ultimate wisdom of holding onto what had depreciated. * * * The plain inference is that the phrase is used in the statute in a sense that would be generally understood in business circles, and we hold that the depreciation claimed by plaintiff in its return is used in that sense, and should have been allowed as a deduction."

No deduction may be taken by a taxpayer on account of the shrinkage in value of an amount invested in foreign money due to a fall in the rate of exchange. The loss allowable in such a case is that actually sustained when the investment is disposed of.[96]

TRANSFER OF SECURITIES AT DEPRECIATED VALUE TO CORPORATION FORMED FOR THE PURPOSE. In a case arising under the 1917 Law, the stockholders of an industrial company owning certain stocks and bonds carried as liquid reserves for opportune purchases of material, established a new corporation having the same stockholders with the same proportionate stock holdings. The new company then bought the above stocks and bonds at market prices which were substantially lower than the cost of market value as of March 1, 1913, of the securities of the old company. A small amount of cash received from the sale of its

[96] O. D. 764, T. B. 1-21-1371.

capital stock was given by the new company in payment for the securities and the balance of the purchase price was given in demand notes bearing 6% interest with the same securities as collateral. The possession of the securities was retained by the old corporation with a power of sale in case of default in payment of the notes. The new corporation had no other assets. The treasury department first held the whole transaction to be a sham and a subterfuge to evade taxation with the result that no loss could be deducted under the alleged sale of the securities by the old corporation.[97]

This ruling was subsequently reversed and the separate entities of the two corporations respected, and it was held that the transfer of securities by the old company to the new company must be recognized as a sale in which the former suffered a dedeductible loss.[98]

Worthless Stock. If stock of a corporation becomes worthless its cost, or, if acquired prior to March 1, 1913, its fair market value as of that date, whichever is lower, may be deducted by the owner in the taxable year in which the stock was ascertained to be worthless and charged off. The worthlessness must be satisfactorily shown as in the case of bad debts. Where banks or other corporations which are subject to supervision by federal authorities (or to state authorities maintaining substantially equivalent standards) in obedience to the specific orders or general policy of such supervisory officers charge off stock as worthless or write it down to a nominal value, such stock shall, in the absence of affirmative evidence clearly establishing the contrary, be presumed for income tax purposes to be worthless.[99]

Sale of Capital Stock. Where the capital stock of a corporation is issued for less than par, the amount of discount is not an allowable deduction to the corporation. Such a transaction is purely a capital transaction and the income of the corporation is not directly decreased by reason of the sale of the stock at a price less than its par value. Neither is any loss or gain realized from the purchase of its own stock.[100]

[97] L. O. 1035 (Rev.), T. B. 40-20-1222.

[98] L. O. 1062, T. B. 14-21-1548. See Chapter 10 for a discussion of the doctrine of corporate entity upon which this decision rested.

[99] Reg. 45, Art. 144, as amended by T. D. 3206, T. B. 33-21-1767; T. D. 2135; T. D. 3261. See p. 647 for a discussion of the deduction of bad debts.

[100] Reg. 45, Arts. 563, 542; T. D. 2090.

Payment by Stockholders of Loss of Corporation. Assessments made by a corporation on its capital stock are regarded as an investment of capital and the amounts paid do not constitute allowable deductions to the stockholders.[101] This rule was held to apply in a case where a corporation showed a deficit at the close of the year and the stockholders agreed to make it good by the payment of voluntary contributions.[102] The surrender of stock for the purpose of wiping out an operating deficit can not be made the basis of a deduction in the returns of the individual stockholders.[103] An assessment paid by a stockholder of a national bank on account of his statutory liability is similarly not deductible. In such a case the assessment under the statutes of the state impose upon the stockholder the necessity of an additional capital expenditure which must be added to the original cost of his stock and his gain or loss can not be determined until this stock is sold or otherwise disposed of in a closed transaction.[104]

Shrinkage or Deterioration in Storage. Loss due to shrinkage or deterioration of produce in storage is not allowed as a deduction. Such shrinkage or deterioration is reflected in the selling price when the goods are sold and correspondingly reduces the net income at that time.[105]

District Irrigation Bonds. District irrigation bonds as a rule, if not always, are a lien upon the real estate affected by the irrigation project and until the corporation has taken such steps as are necessary to protect its rights and enforce the collection of the bonds, it does not appear that the corporation would be warranted in writing out of its assets and deducting from gross income, as a loss, the face value, or any other arbitrarily ascertained amount, representing a loss or shrinkage in the value of such bonds.[106] This ruling was made under the 1913 Law and is now subject to the new provisions of the 1921 Law that losses may in some cases be deducted in years other than those in which sustained.

Losses of Oil and Gas. Losses of oil and gas are of two kinds: (a) Those which are unforeseen or unavoidable, such as losses sustained through fire or accident; and (b) losses that are an-

101 T. D. 2090.

102 Letter from treasury department dated February 21, 1916; I. T. S. 1918, ¶ 1291.

103 O. D. 216, T. B. 11-19-378.

104 A. R. R. 588, T. B. 30-21-1744.

105 Reg. 45, Art. 145; T. D. 2153.

106 T. D. 2152.

ticipated and recognized as unavoidable under operating conditions, such as evaporation of oil in storage, ordinary leakage, refinery losses, etc. Usually the latter class are indeterminate as to amount and are absorbed either implicitly or explicitly in current operating expenses or in cost of the oil or gas. Indeterminate losses may not be deducted from gross income.[107] If a taxpayer purchases royalty interests in tracts of oil land (not including title to the land itself) and such interests prove worthless, as evidenced by all wells drilled proving dry or failing after producing very small quantities of oil, the loss sustained is an allowable deduction from gross income.[108]

Reserves for Losses. Reserves to take care of anticipated or probable losses are not a proper deduction.[109] On the other hand, losses sustained during the year may be deducted although made good out of a fund which has been accumulated as an insurance reserve by the taxpayer.[110] The Revenue Act of 1921 contains a new provision permitting the deduction of a reasonable addition to a reserve for bad debts.[111] Amounts set aside by canners of perishable food products as a reserve against which to charge losses due to climatic and other natural conditions producing shortage of the raw products, are not deductible in computing net income.[112]

Reserves for Cash Discounts. It has been held under the 1918 Law that a corporation keeping its accounts on an accrual basis will not be permitted to deduct from gross income a sum in anticipation of the amount the corporation may be required to allow as cash discount on accounts due and payable in the succeeding year. But any amounts so allowed in the succeeding year before the return is filed may be deducted from gross sales for the previous taxable year.[113]

Worthless Debts. The Revenue Act of 1918 provided that individuals and corporations might deduct debts ascertained to be worthless and charged off within the taxable year.[114] The Revenue Act of 1921 contains the same provision and in addition permits the deduction, in the discretion of the Commissioner, of a reasonable addition to a reserve for bad debts and authorizes the

[107] Manual for Oil and Gas Industry.

[108] O. D. 375, T. B. 3-20-691.

[109] Reg. 33 Rev., Art. 166; T. D. 2161.

[110] Reg. 33, Art. 122.

[111] Revenue Act of 1921, §§ 214 (a) (7) and 234 (a) (5).

[112] T. B. R. 13, T. B. 3-19-187.

[113] O. D. 146, T. B. 4-19-228.

[114] Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.

Commissioner, when satisfied that a debt is recoverable only in part, to allow such debt to be charged off in part.[115] It should be remembered that the following discussion is in the light of rulings made under the 1918 Law and that the deduction of amounts for bad debts under the present law will be subject to the additional provisions above stated. For the purpose of deduction as losses, debts are divided into two classes, (a) those which represent to the creditor a return of capital and (b) those which represent unpaid income. The former may be deducted regardless of when the debt became due and payable, but the latter, such as uncollected wages, salaries, rents, interest and similar items of taxable income, may not be deducted, if the debt became due on or after March 1, 1913, unless the amount thereof has been reported as income; but if the debt became due and payable prior to March 1, 1913, it may be deducted in any event.[116] The losses which may be deducted are losses of capital; income on which the tax has been assessed assumes the status of capital, and income which became due and payable before the incidence of the tax is capital to the taxpayer, although it may be received thereafter. The mere failure to receive income does not warrant a deduction, as the omission of such amounts operates, in itself, as a reduction of tax. If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation. In the case of debts existing prior to March 1, 1913, only their value on that date may be deducted upon subsequently ascertaining them to be worthless. An account merely written down or a debt recognized as worthless prior to the beginning of the taxable year is not deductible.[117] Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted as a bad debt. The difference between the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate and the amount of his claim may be considered a worthless debt. A purchaser of accounts receivable which can not be collected and are consequently charged off the books as bad debts is entitled to deduct them, the amount of de-

[115] Revenue Act of 1921, §§ 214 (a) 7 and 234 (a) 5.
[116] T. D. 2224.
[117] Reg. 45, Art. 151.

duction to be based upon the price he paid for them and not upon their face value.[118]

A taxpayer indorsed the notes of a corporation prior to March 1, 1913; the notes became due prior to that date, the corporation being insolvent at the time they fell due and ever since. The taxpayer obtained extensions of the notes from time to time in the name of the corporation, endorsed the new notes and paid installments of principal and interest in 1917, 1918 and 1919. At no time had he become primarily liable on the notes nor had he ever given any written agreement to make such payments. It was held that he suffered no actual loss until he made the first payment in liquidation of the principal and interest thereon. When each payment was made it created a debt in his favor from the makers of the notes, which debt was at the time it was created definitely known to be worthless. Each additional payment created an additional debt and the taxpayer was allowed to deduct in each year the amount of his payments on the notes.[119]

A transaction in which the majority stockholder of a corporation, to whom the corporation was heavily indebted, agreed to take as payment the free assets of the company and to assume its liabilities other than its bonded indebtedness is considered a cancellation of the debt and any loss sustained by the majority stockholder is deductible only in the return for the year when the transaction took place, and not when the assets were disposed of subsequently. The measure of the loss would be the difference between the liabilities assumed, including the debt to the majority stockholder, and the value of the assets at the time received by him.[120]

A certain taxpayer was notified by his bank that a note had gone to protest and that he, as one of the indorsers, was liable for the payment thereof. In order to defend a relative who had forged the indorsement, the taxpayer gave the bank another note of the same face value. The taxpayer made arrangements with his relative whereby the relative was to pay the amount of the note on the installment plan. The relative, however, made no payments in the year 1919 and payment could not be enforced since he had no assets. During that year the taxpayer paid the note in full to the bank and deducted as a bad debt for the year 1919 the difference between the amount paid the bank and the

[118] Reg. 45, Art. 152.
[119] A. R. R. 479, T. B. 38-21-1837.
[120] A. R. R. 30, T. B. 9-20-772.

amount by which he had been reimbursed by his relative. It has been held that the amount deducted is allowable since it represented a debt due from the relative and not a gift to him.[121]

Must Be Charged Off on Books. The Revenue Act of 1918 and the Revenue Act of 1921 both expressly provide that in the case of both individuals and corporations worthless debts must have been "charged off" in the year in which they are claimed as a deduction.[122] In 1919, a corporation purchased notes from a merchant and advanced sums of money to him on bills of sale. In January, 1920, it developed that the notes were forged and the bills of sale were fraudulent. The losses were charged off the books on March 12, 1920. It was held that the losses are deductible as bad debts rather than other losses in the taxable year 1920, when they were ascertained to be worthless and charged off, regardless of when they actually became worthless.[123]

When Debts May Be Considered Worthless. The following discussion will be subject to the provision of the present law permitting the deduction of so much of a debt as is ascertained to be worthless when the Commissioner is satisfied that the debt is recoverable only in part. To determine whether or not a debt is worthless it is not essential that an unsatisfied judgment shall exist or a judicial determination be reached or that the bad debt or account shall be proved worthless by legal proceedings. Before a deduction will be allowed the taxpayer must, however, not only be satisfied that the debt or account is worthless, but must be able to satisfy the Commissioner or collector that the accounts charged off were definitely determined at the time to be worthless and that they had not been recognized as worthless or without value prior to the beginning of the year for which the return is made.[124] Bankruptcy may or may not be an indication of the worthlessness of a debt, and actual determination of worthlessness in such a case is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had. Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year confirming the conclusion that the debt is worthless will not authorize shifting the deduction to such later year.[125] Where an in-

[121] O. D. 934, T. B. 22-21-1663.

[122] Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5; Revenue Act of 1921, §§ 214 (a) 7 and 234 (a) 5.

[123] O. D. 604, T. B. 30-20-1090.

[124] Reg. 33 Rev., Art. 151; Reg. 45, Art. 151.

[125] Reg. 45, Art. 151.

debtedness is claimed and contested and a settlement is had by way of compromise whereby an amount, less than the debt claimed, is accepted in full payment and satisfaction of the debt, the difference between the amount paid and that claimed is not allowable as a deduction for worthless debts. If the settlement in compromise consists of a promise to pay an amount less than the debt claimed, an accord and satisfaction is established and the amount promised to be paid forms the basis of a new transaction. Upon the breach of this promise the question will arise as to the deductibility of the new amount only.[126] Whenever the debtor is legally discharged from his obligation either by the running of the statute of limitations, by bankruptcy proceedings, by accord and satisfaction, by formal release, or by any other method, it seems that the creditor may claim the amount of loss sustained as a deduction. As indicated by the ruling above, it may be possible under other conditions to deduct the amount of a debt but the circumstances must be such as to indicate beyond doubt that the debt can not be collected. Where all of the surrounding and attendant circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would not in all probability result in the satisfaction on execution of a judgment, a showing of these facts will be sufficient showing of the worthlessness of the debt for purposes of deduction.[127] A mere voluntary forgiveness of the debt would not make the amount thereof an allowable deduction, since such voluntary action on the part of the creditor would be tantamount to a gift.

[126] Reg. 33 Rev., Art. 8; O. D. 297, T. B. 24-19-564. The regulation cited reversed the Treasury Department's previous ruling that the unpaid portion of a compromised debt might be claimed as a deduction.

[127] Reg. 45, Art. 151; Reg. 33 Rev., Art. 8; U. S. v. Mayer, 26 Fed. Cas. No. 15, 753. In U. S. v. Frost, 25 Fed. Cas. No. 15,172, a prosecution for making a false income tax return for the year 1866, the court made the following observation regarding the provision of the statute permitting the deduction of worthless debts: "The language is, 'ascertained to be worthless'. By whom or how? The law is silent on this important point, and therefore there must be a discretion given to the person making his returns, and if that discretion is used fairly and honestly there would seem to be no just ground of complaint. It certainly can scarcely be contended that every debt must be ascertained to be worthless by a suit at law, or in equity, for that would be impracticable, and therefore such cannot be the meaning of the law. It is undoubtedly very difficult to lay down any rule of universal application to this class of cases, and yet the want of precision in the law may have led to this prosecution, and may lead to others, and, perhaps, on the whole, it would be better to give, by law, a clearer and simpler definition than now exists of the terms 'gains, profits and income'."

Where a taxpayer extends the time of payment of a note he is not allowed at such time to deduct the difference between the face value of the note and its fair market value as a bad debt. The debt has not at the time it is extended been determined worthless and charged off.[128] It is not necessary, however, that a bad debt be evidenced by a "closed and completed" transaction. Thus, where a company which had on deposit a sum of money with a bank which failed in 1918, wrote off and deducted as a bad debt one-half this amount on the basis of information from the receiver that only one-half such indebtedness would be recovered in liquidation, it has been held that this was a proper deduction by the company, since at no time after the failure of the bank was there any doubt that a loss had been suffered and since the company relied upon the best information obtainable and not upon its own judgment and since the subsequent distribution and liquidation confirmed the correctness of the statement of the receiver.[129] Under the 1918 Law a taxpayer would not be permitted a deduction for a bad debt even where in the year in which such deduction was claimed there was evidence that a substantial part of the debt would not be recovered and although from his knowledge of conditions existing he was justified in believing that in the event of foreclosure his loan would result in a loss.[130] Under the present law it would seem that a deduction for so much of the debt as can be shown to be worthless would be deductible. It has been held that where the Supreme Court of a state in 1919 affirmed the judgment of a lower court rendered in a prior year, holding that a bank could not recover on certain notes, the bank may deduct the amount of the loss in 1919, the final judgment of the Supreme Court fixing the time when the debt was ascertained to be worthless.[131]

Effect of War Conditions on Deduction of Debts. Debts due by one belligerent state to the citizens of another state are not extinguishable by war. Consequently, a taxpayer having an outstanding claim against the German government, dating before the war, would not be justified in charging the amount of the claim as a loss when war was declared between the United States and the German government.[132] Where as a result of the Cuban moratorium certain accounts receivable due from customers in Cuba prior to the close of 1920 were uncollectible at the close of

128 O. D. 979, T. B. 30-21-1742.
129 A. R. R. 352, T. B. 52-20-1362.
130 A. R. R. 365, T. B. 6-21-1432.
131 O. D. 965, T. B. 27-21-1713.
132 A. R. M. 31, T. B. 9-20-771.

that year, it has been held that no deduction could be taken therefor until it had been ascertained that the accounts were worthless and charged off on the books. There was at the end of 1920 no means of ascertaining what portion of these accounts was good and what portion worthless. The fact that the moratorium made the debts uncollectible on their due dates did not lead to the conclusion that nothing would ever be realized on them.[133]

DEPOSITS IN RUSSIAN BANKS. Bank deposits in Russian banks can not be considered as worthless for the purpose of claiming a deductible loss in a return for the taxable year 1919. Russian rubles in the form of bank deposits were sold during the latter months of 1919, which would indicate that they were not at that time worthless.[134] It has also been held that where a taxpayer owned Russian rubles deposited in Russian banks and offered these deposits for sale in 1920 but could find no market for them, no deductible loss is sustained unless he can submit evidence that the banks, in which the deposits in question were made, had lost their identity as banking institutions or that they had been taken over by the Soviet Government and their funds requisitioned, confiscated or dissipated.[135] Where, however, a taxpayer purchased credits on Russian banks and it appeared that all efforts to communicate with the Russian banks had proved futile, the New York bank from which the credits were purchased having been informed by the state department that there were no postal facilities with Petrograd, and the New York bank's Swedish correspondent having been unable to communicate with the Russian banks and information from other sources indicating that the assets of the Russian banks had been taken over and dissipated by the Russian Soviet Republic, other information indicating that the banks had been looted by the revolutionists, the amounts paid for the credits were permitted to be deducted as a worthless debt in 1918. Even though a stable Russian government should fulfill international obligations and restore the ruble to a normal parity of exchange, such action would not necessarily affect the Russian banks against which the credits were issued.[136]

FORECLOSURE OF MORTGAGES. Where mortgaged or pledged property is sold, in the manner prescribed by law to satisfy the debt secured, for less than the debt, and the mortgagee or pledgee at that time or thereafter ascertains that the por-

[133] O. D. 891, T. B. 17-21-1594.
[134] O. D. 535, T. B. 23-20-986.
[135] O. D. 923, T. B. 21-21-1649.
[136] A. R. M. 64, T. B. 27-20-1041.

tion of the indebtedness remaining unsatisfied after such sale is uncollectible, and charges it off, he may deduct such amount as a bad debt for the taxable year in which it is ascertained to be worthless and charged off. Accrued interest may be included as part of the deduction only when it has previously been returned as income.[137] This ruling modifies the former rule that where a mortgagee bought in the mortgaged property, the difference between the purchase price and the indebtedness was not allowable as a bad debt. The determination of loss in such case was deferred until the property was disposed of.

A mortgage is a security for a debt or obligation and an incident thereto; a debt or obligation of some kind is an essential element of a mortgage.[138] A second mortgage is a mortgage without intervening liens between it and the first mortgage.[139] A creditor whose debt is secured by a mortgage has two remedies —one *in personam* for his debt, and the other *in rem* to subject the mortgaged property to its payment.[140] Where a mortgage is given to secure the payment of a debt, the creditor may pursue his remedy either on the mortgage or on the evidence of the debt, or on both concurrently.[141] Where the proceeds of a foreclosure sale are not sufficient to satisfy the mortgage debt, the mortgagee may thereafter maintain an action at law against the person liable for such deficiency.[142] Since the mortgagee may maintain an action against the mortgagor for the amount of the debt, it is not sufficient, in order to deduct the amount as a bad debt, that he show only a failure of the security, as the mortgagor may be solvent and the debt collectible; but he also must show that legal action against the mortgagor resulted in no recovery, or that such action would in all probability not result in the satisfaction of execution on a judgment. If the debt existed prior to March 1, 1913, only its value on that date may be deducted upon subsequently ascertaining it to be worthless.[143]

WORTHLESS SECURITIES. Where bonds purchased before March 1, 1913, depreciated in value between the date of purchase and that date, and were in a later year ascertained to be worthless and charged off, the owner is entitled to a deduction in that year equal to the value of the bonds on March 1, 1913. Bonds

137 Reg. 45, Art. 153, as amended by T. D. 3265; Reg. 33 Rev., Art. 8.
138 Carrol v. Tomlinson, 192 Ill. 398, 61 N. E. 484.
139 Appeal of Green, 97 Pa. 342.
140 Silvey v. Axley, 118 N. C. 959, 23 S. E. 933.
141 Ober v. Gallagher, 93 U. S. 199.
142 Shepherd v. May, 115 U. S. 505.
143 O. D. 687, T. B. 42-20-1244.

purchased since Februray 28, 1913, when ascertained to be worthless, may be treated as bad debts to the amount actually paid for them, but not exceeding their amortized value if purchased at a premium. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year. To authorize a deduction for a bad debt on account of notes held prior to March 1, 1913, their value on that date must be established.[144] Because of disturbed political conditions in Russia there is little hope that bonds of the Imperial Internal Russian 4 per cent. loan of 1894 will be redeemed. A holder of such bonds which were purchased in 1916, who was unsuccessful in finding a market for them during the year 1919, was held to be entitled to a deduction from his gross income for that year to the extent of the amount actually paid for them, provided, however, that such amount was charged off the taxpayer's accounts for the year 1919 and a corresponding reduction made in his surplus account.[145]

Reserves for Bad Debts and Charging Off Bad Debts in Part Under 1921 Law. The following rulings were issued as this book was going to press: The 1921 Law changes the previous practice in two particulars—1st, by recognizing a reserve for bad debts, and 2nd, allowing a debt to be charged off in part. Under this provision, bad debts may be treated in either of two ways; (1) by a deduction from income in respect of debts ascertained to be worthless in whole or in part, or (2) by a deduction from income of an addition to a reserve for bad debts. For the year 1921 taxpayers may, regardless of their previous practice, elect either of these two methods and will be required to continue the use in later years of the method so elected unless permission to change to the other method is granted by the Commissioner.

Where all the surrounding and attending circumstances indicate that the debt is worthless, either wholly or in part, the part thereof which is worthless and charged off or written down to a nominal amount on the books of the taxpayer will be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction will be allowed for the part of a debt ascertained to be worthless and charged

[144] Reg. 45, Art. 154.
[145] O. D. 748, T. B. 50-20-1343.

off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is charged down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt previously charged off in whole or in part, and allowed as a deduction for income tax purposes, in excess of the amount not charged off, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

Taxpayers who have, prior to 1921, maintained reserve account for bad debts may deduct a reasonable addition to such reserves in lieu of a deduction for specific bad debt items. Taxpayers who have not heretofore maintained such reserve accounts may now elect to do so and in such case, must proceed to determine the amount of the reserve that should reasonably have been set up as at December 31, 1920 (which may not be deducted in computing net income), and in respect of 1921 and subsequent years, may add a reasonable addition to such reserve and deduct the amount in computing taxable net income. Where a reserve account is maintained, debts ascertained to be worthless in whole or in part should be charged against the reserve and not deducted from income. What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts and will vary as between classes of business and with conditions of business prosperity. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year.

Where banks or other corporations which are subject to supervision by federal authorities (or by state authorities maintaining substantially equivalent standards) in obedience to

the specific orders or in accordance with the general policy of such supervisory officers, charge off debts in whole or in part, such debts will, in the absence of affirmative evidence clearly establishing the contrary, be presumed, for income tax purposes, to be worthless or recoverable only in part, as the case may be.

Accrued interest may be included as part of the deduction for bad debts only when it has previously been returned as income.

A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuation. Where a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations and is able to so demonstrate to the satisfaction of the Commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations.

Where mortgaged or pledged property is lawfully sold (whether to the creditor or other purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. Where a taxpayer buys in mortgaged or pledged property for the amount of the debt, no deduction will be allowed for any part of the debt. Gain or loss is realized when the property bought in is sold or disposed of.[145a]

Loss Due to Adverse Judgment. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement, or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise.[146] Where a taxpayer sold a farm and the purchaser later sued him for damages alleging misrepresentations, and judgment was given for the plaintiff and paid by the taxpayer in 1919, it has been held that the amount paid as damages may be deducted in 1919 since it appeared that the damages

145a T. D. 3262.

146 Reg. 45, Art. 111. See Chapter 33 for a further discussion of this subject.

paid grew out of a sale made in the course of the taxpayer's regular business.[147] In a case where a corporation was sued for infringing a trade name covering a period ending in 1912, and judgment was obtained against it in 1916, the treasury department held that the amount of this judgment should be prorated over the period ending in 1912 according to the income of each year. The part found by this method to be applicable to the income of the corporation for the period of 1909 to 1912 would be referable to those years, but no part of this sum would be deductible as a loss in the return of income for 1916. The same corporation also paid, in 1916, an additional sum, as consideration for dismissal of a pending suit for interest on the above judgment from the date of the decision of the court to the date of payment and for the unrestrained use of the trade name in question. It was held by the treasury department that if this amount could be segregated between interest and use, it might be prorated the same as in the other case, for the period subsequent to 1912, and such part thereof as would be found applicable to the 1916 income would be deductible under the heading of business expense and interest respectively. If no segregation could be made the entire amount might be treated as business expense.[148] The language of the present and 1918 Laws differ from that of preceding laws in that they permit the deduction of losses sustained during the taxable year, whether charged off or not, and seems to imply that the loss shall be deducted from the net income of the year in which it was sustained notwithstanding the ascertainment thereof through an adverse judgment in a subsequent year, unless the deduction thereof in another year will more clearly reflect income.[149] If on suit for damages the amount recovered is less than the damage sustained or less than an amount necessary to make good the damage, the difference between the actual amount of damage sustained and the amount recovered will be deductible as a loss by the judgment creditor or prevailing party.[150]

Recoveries on Losses. All the statutory provisions regarding the deduction of losses limit the deductible losses to those "not compensated for by insurance or otherwise".[151] Where a loss

[147] O. D. 978, T. B. 29-21-1734.

[148] Letter from treasury department dated February 9, 1917; I. T. S. 1918, ¶ 1427.

[149] See Revenue Act of 1918, §§ 214 (a) 4, 5, 6, and 234 (a) 4.

[150] Reg. 33 Rev., Art. 94.

[151] Revenue Act of 1921, §§ 214 (a) 4, 5, 6 and 234 (a) 4; Revenue Act of 1918, §§ 214 (a) 4, 5, 6 and 234 (a) 4. See also Chapter 33.

occurs in one taxable period, and compensation therefor, or recovery thereon, in whole or in part, occurs in a subsequent taxable period the question arises whether the amount of the compensation or recovery is taxable as income in the year received or is to be applied in reduction of the original loss through the medium of amended returns. The rulings on this point under the 1918 Law are indicated in the following paragraphs.

EMBEZZLEMENTS RECOVERED. A loss incurred by a corporation through embezzlement is an allowable deduction from gross income for the year in which the embezzlement occurred. Where the embezzlement is not discovered in the taxable year but is later discovered and admitted by the embezzler, a part of the money being promptly recovered, the amount so recovered tends to diminish the amount of allowable deductions on account of the embezzlement for the year in which the embezzlement occurred, and is ordinarily not returnable as income in the year when received.[152] If fidelity insurance is recovered, it should be treated as indicated in the next paragraph.

INSURANCE RECEIVED IN SUBSEQUENT YEAR. Where embezzlement by a bonded employee occurs, there is no loss as to the amount of insurance recoverable even though it is not received in the same taxable period. The claim against the bonding company is considered the equivalent of cash.[153] When an insured loss occurs in one taxable year and the insurance is not recovered during that year the taxpayer should compute his loss by deducting from the total loss the estimated amount of the recoverable insurance. The loss so determined should be deducted from the taxpayer's gross income of the year in which the loss

152 O. 845, T. B. 6-19-279, modifying Solicitor's memorandum 698; U. S. v. Cleveland, Cinn., Chicago & St. Louis Ry. Co., U. S. Dist. Ct., So. Dist. Ohio, February 23, 1916 (not reported). In the last mentioned case, prior to 1909 covering a period of several years, the treasurer of the defendant railway company had embezzled a large sum of money, but the embezzlement was not discovered until the year 1909. The defendant claimed a deduction of this amount from its gross income under the Act of August 5, 1909, which, like the present statute, limited the deductions on account of losses to those "actually sustained during the year." The court said: "The time of the discovery of a loss bears no relation to the date the loss was sustained. The loss was sustained when the theft occurred, although the defendant did not know at the time of the depletion of its assets. As each embezzlement occurred, the defendant was poorer to the extent of it. It then sustained a loss. One of the definitions of 'sustained' is 'undergo'. As each embezzlement occurred, the defendant underwent the loss of that much money. It is clear that the defendant is not entitled to the deduction claimed." See, however, T. D. 3261 under the 1921 Law.

153 O. 845, T. B. 6-19-279; O. D. 165, T. B. 6-19-273.

was sustained. If subsequent events demonstrate that this estimate was substantially incorrect, an amended return should be filed correcting the mistake.[154]

Net Losses Under the 1918 Law. The Revenue Act of 1918 contained a new provision for the allowance of certain "net losses." When used in connection with this provision of the 1918 Law, the term "net loss" referred only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the *bona fide* sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the recent war; and when so resulting meant the excess of the deductions allowed by law (excluding in the case of corporations amounts received as dividends from a corporation taxable upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax had been imposed) over the sum of the gross income plus any interest received free from income or excess-profits taxes. The amount of net loss claimed must have represented an actual net loss over and above all income, including tax-free income. Such losses were allowable only in respect of a taxpayer having a taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, and after one claim had been allowed no further claim would be considered. It was further provided that the benefit of the provisions respecting the allowance of net losses might be allowed to the members of a partnership and the beneficiaries of an estate or trust under regulations prescribed by the Commissioner with the approval of the secretary.[155]

A corporation whose taxable year was not included in the period between October 31, 1918, and January 1, 1920, was not

[154] T. B. R. 55, T. B. 18-19-482.

[155] Revenue Act of 1918, 204; Reg. 45, Art. 1601. The following statement contained in the Senate Committee report upon the Revenue Act of 1918, throws additional light upon § 204 of the statute providing for the deduction of net losses: "One of the most important provisions inserted by the committee is quite new to our tax laws. At the present time no recognition is given to net losses; that is, if in any year the losses and expenses of a taxpayer exceed his gross income the excess (or in other words, the net loss) can not be carried over into the next year. For purposes of taxation the settlement must be made upon the basis of each year's business by itself. The chief merit of the present plan is its simplicity of administration. But it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice."

entitled to the relief afforded by the 1918 Law net loss provision. Consequently a corporation doing business on a fiscal-year basis might not allocate its net loss and deduct the amount apportioned to that part of its fiscal year falling within the period October 31, 1918, to January 1, 1920.[156] A corporation which had previously operated as a partnership incorporated on June 30, 1919. The accounting period of the partnership, as well as that of the corporation, was a calendar year. During the calendar year 1918 the partnership earned a net income, and during the period from January 1 to June 29, 1919, it suffered a net operating loss. The corporation also suffered a net operating loss during the period from June 30 to December 31, 1919. It was held that since neither the net operating loss sustained by the partnership nor the net operating loss suffered by the corporation was a loss for a full taxable year, neither organization was entitled to deduct the amount of its net loss from the net income for either the preceding or succeeding taxable year.[157] If a taxpayer changed his accounting period in such manner that the period from the close of his previous taxable year to the close of his newly established taxable year fell between October 31, 1918, and January 1, 1920, and he sustained a net loss during such fractional year period, he was not entitled to the relief provided by the net loss provision of the Revenue Act of 1918, since the net loss sustained was not for a full taxable year as provided by the Act.[158] A company which earned a large income during the fiscal year ending September 30, 1918, and which suffered a net loss during the year ending September 30, 1919, was not permitted to change its accounting period for 1918 to the calendar year basis so as to be allowed to deduct the above net loss from taxable income for the calendar year 1918. The accounting period ending September 30, 1918, for which the large tax liability had accrued and the method of accounting employed during that period were accomplished facts which could not be changed by the Commissioner.[159]

Claim for Allowance of Net Loss. A taxpayer having such a net loss might file a claim on form 46 with his return of in-

[156] O. D. 511, T. B. 21-20-947.

[157] O. D. 855, T. B. 13-21-1529. If, however, the organization is qualified and elects to take advantage of the provisions of section 330 of the Revenue Act of 1918 and article 933 of Regulations 45, it is then entitled to seek relief under the "net loss" provision of the statute by applying the total net operating loss sustained during the entire year 1919 against the net income of the year 1918 and applying the excess, if any, of the 1919 loss over 1918 net income against the net income of the year 1920.

[158] O. D. 445, T. B. 15-20-841.

[159] T. D. 3044, T. B. 30-20-1087.

come for the taxable year 1919. Such claim was required to contain a concise statement setting forth the amount of the loss sustained, in accordance with the accompanying return, the nature of the loss, the amount of the taxpayer's net income for the taxable year 1918, the taxes paid by him with respect thereto, and all pertinent facts necessary to enable the Commissioner to determine the allowability of the claim.[160]

Allowance of Net Loss. The amount allowed by the Commissioner in respect of any such claim was deducted from the net income for the taxable year 1918 and the income and the war-profits and excess-profits taxes, if any, for such year were recomputed accordingly. Any amount found to be due him was credited or refunded to the taxpayer. In any case in which it was found by the Commissioner that such net loss was in excess of the net income of such preceding taxable year, the taxpayer might carry forward the amount of such excess and claim it as a deduction in computing net income for the succeeding taxable year.[161] If a taxpayer suffered a net loss for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, and *had no net income* for the preceding taxable year, the entire amount of the loss was deductible in computing net income for the succeeding taxable year.[162] There was no provision in the law whereby income received in a year subsequent to 1920 might be reduced on account of a loss sustained for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920.[163]

Net Losses Under the 1921 Law. The 1921 Law has extended the limited relief, afforded by the 1918 Law, to taxpayers having net losses in any taxable year beginning after December 30, 1920. The term "net loss" when used in this connection means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business), and when so resulting means the excess of the deductions allowed by the law over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from income tax exceeds so much of the interest paid or accrued

160 Reg. 45, Art. 1602.
161 Reg. 45, Art. 1603.
162 O. D. 431, T. B. 14-20-823.
163 O. D. 860, T. B. 14-21-1539.

within the taxable year on indebtedness as is not allowed to be deducted from gross income, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4) amounts received as dividends and allowed as a deduction, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost.

If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof will be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess will be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

The benefit of the net loss provision will be allowed to the members of a partnership and the beneficiaries of an estate or trust, and to insurance companies (other than mutual insurance companies) under regulations prescribed by the Commissioner with the approval of the Secretary.

If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer will be entitled to the benefits of the net loss provision in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

The following rulings were made under the 1918 Law but would seem to be applicable under the present law. A net operating business loss in 1919 occasioned by floods is a net loss.[164] A 1918 loss due to the failure and liquidation of two corporations in which an individual owns stock is not a net loss, but is merely a loss on securities.[165] An individual who sustained a net loss for a taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, with respect to his share of partnership earnings is not entitled to the relief provided by the net loss provision of the Revenue Act of 1918 unless he has

[164] O. D. 367, T. B. 3-20-681.
[165] O. D. 380, T. B. 4-20-703.

sustained a net loss for such taxable year with respect to his entire income derived from all sources during that year.[166]

Special Provision of 1918 Law Concerning Losses in Inventory and from Rebates. The Revenue Act of 1918 contained a new provision regarding losses sustained after the close of the taxable year 1918. This relief provision applied only to certain losses, which, while actually sustained after 1918, were attributable to that year. The provision was inserted in the 1918 Law in the belief that prices would fall rapidly after 1918. It was provided that a taxpayer might file, at the time of filing return for the taxable year 1918, a claim in abatement based on the fact that he had sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by the claim was not required until the claim was decided, but the taxpayer was required to accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim was disallowed, the remainder of the tax due, on notice and demand by the collector, was required to be paid by the taxpayer with interest at the rate of one per centum per month from the time the tax would have been due had no such claim been filed. If it was shown to the satisfaction of the Commissioner that such substantial loss had been sustained, then in computing the income tax the amount of such loss was deducted from the net income. Where no such claim was filed, but it was shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer had sustained a substantial loss of the character above described, the amount of such loss was deducted from the net income for the taxable year 1918 and the income tax imposed for such year was redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination was credited or refunded to the taxpayer.[167] These deductions might be secured by two methods, either by a claim

[166] O. D. 430, T. B. 14-20-822.

[167] Revenue Act of 1918, §§ 214 (a) 12, 234 (a) 14.

in abatement or by a claim for refund, and could not be entered upon the regular return.[168]

In a case in which a corporation, engaged in manufacturing patent flours, sold during 1918 large quantities of flour manufactured from substitutes in accordance with regulations issued by the food administration and abolished upon the cessation of hostilities, which flour the corporation took back in the first six months of 1919 and resold, the treasury department has held that the difference between the amount of returned flour and the amount thereof resold and the inventory thereof remaining could not be deducted as a loss in inventory or from rebates. It did not appear in this case whether there was an actual loss sustained by this taxpayer through the resale of these goods below cost of manufacture, or whether the so-called "loss" was merely a reduction in the amount of profit that would have been made if the goods had not been taken back from the jobbing houses; but this had no material effect upon the case. Whether or not the taxpayer accepted the return of such goods in 1919 appears to have been a matter entirely at its own option and if, as a matter of business prudence and expediency, it decided so to do, the resulting loss, if any, was due to its own act and by its own election in 1919, and was held not to be such a loss as can be properly charged, under the law, against the profits of the year 1918.[169]

LOSS IN INVENTORY. Inventory losses were allowable either (a) where goods included in an inventory at the end of the taxable year 1918 were sold at a loss during the succeeding taxable year, or (b) where such goods remained unsold throughout the taxable year 1919 and at its close had a then market value (not resulting from a temporary fluctuation) materially below the value at which they were inventoried at the end of the taxable year 1918. No deduction was allowable for losses of anticipated profits or for losses not substantial in amount, nor for physical damage or obsolescence occurring in the taxable year 1919. If, for example, the inventory contained discontinued off colors in broken lots and the salable colors had been disposed of and the stock broken before the close of the taxable year 1918, the element of obsolescence if definitely determined should have

[168] Reg. 45, Art. 261; Telegram from Treasury Department dated March 3, 1918; I. T. S. 1919, ¶ 3276. Copies of inventories were not required to be filed with the return but taxpayers should retain for a period of not less than five years all original inventory sheets and all papers which would have any bearing on a claim for loss in inventories (including sales slips). (I. T. S. 1919, ¶ 3358).

been taken into account in both the inventory made at the close of the taxable year 1918 and that made at the close of the taxable year 1919. If it was impossible to get the market value for such colors in broken stocks, the taxpayer would be required to await the sale of such broken stocks in order to determine the loss involved; but in most instances a reasonable and fair estimate of the market value could be made. If the salable colors were disposed of after the close of the taxable year 1918, the accompanying obsolescence in the remaining stock took place in the year 1919 and the deduction should have been taken not as a loss in inventory but as obsolescence occurring in the taxable year 1919.[170] In determining whether goods included in an inventory at the end of the taxable year 1918 had been sold during the succeeding taxable year, and whether loss had resulted therefrom, sales of goods made in the taxable year 1919 were deemed to have been made from the inventoried stock of 1918 until such inventoried stock was exhausted.[171] All goods where title had actually passed to the taxpayer were required to be included in the inventory, and as a result thereof were eligible for consideration in any claim in abatement. It was necessary that title should have passed to the taxpayer in 1918, and goods merely ordered for future delivery and for which no transfer of title had been effected, were excluded. Where a taxpayer's fiscal year ended on November 30, 1919, and inventory was taken on that date, the claim in abatement could only apply to goods which were the property of the taxpayer up to that date, but no claim could be made on any materials which had become the property of the taxpayer between December 1 and 31, inclusive, of that year.[172] Where a claim for inventory loss was finally allowed, the net income for 1919—as established by usual accounting methods—would be correspondingly higher as reported in the return for the taxable year 1919. In other words, the item of loss which would normally find its way into 1919 operating accounts was thrown back against 1918 income. It was recommended that the accounting records of the taxpayer be not changed but that any adjustment of inventories be recorded in distinct accounts supported by adequate detailed schedules. In

[169] A. R. R. 155, T. B. 26-20-1028.

[170] I. T. S. 1919, ¶ 3363. Much of the text of this and the following paragraphs on losses in inventory is based upon the published answers of the Advisory Board to a series of questions submitted by the Southern Wholesale Drygoods Association in May, 1919.

[171] Reg. 45, Art. 263.

[172] I. T. S. 1919, ¶¶ 3360, 3361; see Reg. 45, Art. 1581.

arriving at the net operating profits for any year, the income, excess and war-profits taxes to be paid on such profits were not taken into consideration. Such taxes, therefore, were theoretically paid out of surplus for the year. If at a subsequent date any of such taxes were refunded, they should not have been recorded in the operating accounts, but should have been credited directly to surplus.[173]

The above provision of the 1918 Law permitting taxpayers to file at the time of making returns for the taxable year 1918, claims in abatement based on losses in inventory due to material reduction in the value of the inventory only operated to relieve the taxpayer from payment of tax at that time. The fact that when the return for 1918 was filed the value of the inventory might be substantially lower than at the close of 1918 was not conclusive that his claim in abatement would be allowed. The inventory loss contemplated was for the full taxable year 1919. The fractional part of the year (January 1, 1918, to the time of filing the return for 1918) did not determine a gain or loss for the period of taxation. The question whether a loss in inventory which could be thrown back into 1918 had been sustained could not be finally determined until the close of 1919.[174]

A company which earned a large income during the fiscal year ending September 30, 1918, and which suffered a net loss during the year ending September 30, 1919, because of certain non-cancellable contracts for the future delivery of materials which were not completed for delivery prior to the termination of the fiscal year ending September 30, 1918, the value of this material having been greatly decreased as a result of the signing of the armistice on November 11, 1918, has been held not to be entitled to a deduction for inventory loss. The company did not own the material on September 30, 1918, but had only a contract for its purchase. Such material was not properly included in its inventory for such taxable period nor was the amount due under the contract for the material entered on the books during such period as a liability. In other words, the loss suffered was not a loss "resulting from any material reduction * * * of the value of the inventory *for such taxable year*." The phrase "substantial loss of the character above described" does not enlarge the definition of inventory losses contained in the earlier part of the subdivision of the statute authorizing the deduction of such losses.[175] Goods or-

[173] I. T. S. 1919, ¶ 3369.
[174] A. R. R. 487, T. B. 18-21-1609.
[175] T. D. 3044, T. B. 30-20-1087.

dered in 1918 and delivered in 1919, where title had not passed until subsequent to the close of the taxable year 1918, could not be included in the 1918 inventory, and any loss realized upon such transactions were losses of the taxable year 1919.[176]

An inventory loss could not be proven by evidence showing that a loss had been sustained in respect of a part of the inventory, without showing that the amount of the loss for which the claim was filed had not been offset by profits made on the remainder of the inventory. The term "temporary fluctuation," means a fluctuation in prices, which does not develop into a steady settled market.[177]

In fixing the cost of the manufactured articles inventoried, all of the costs of manufacture applicable to the particular article might be taken into consideration, but no claim would be allowed for speculative or anticipated profits. No claim should have been made for the loss of an anticipated profit on labor or material used in producing the articles.[178]

An established loss through reduction after the close of the taxable year 1918 in the value of liquor inventoried at the close of that year and remaining unsold at the close of the taxable year 1919 constituted an allowable deduction. The lack of market for and lack of market value of the liquor was required to be established.[179]

Shrinkage in inventory values sustained during 1919 by a partnership business which prior to November 4, 1918, was operated as a corporation might not be taken as a deduction from the net income of the corporation for the taxable year 1918, even though the individual partners were stockholders of the former corporation.[180]

In the case of a taxpayer making a return for a fiscal year beginning of 1917 and ending in 1918, the provisions relating to loss in inventory, apply to the computation of the tax under

[176] T. B. R. 15, T. B. 5-19-251.

[177] T. B. M. 52, T. B. 12-19-52; A. R. R. 291, T. B. 43-20-1260. The rule stated in the text above that an inventory loss could not be sustained except with reference to the entire inventory could hardly have been intended to supersede the requirement that inventories must be valued at "cost or market whichever is lower". In other words appreciation in value of part of the inventory, where such appreciation raised the market value of such part above cost, would not be entirely offset against the depreciated part of the inventory if goods were valued at "cost or market whichever is lower".

[178] O. D. 47, T. B. 1-19-64.

[179] O. D. 390, T. B. 5-20-717.

[180] O. D. 263, T. B. 17-19-471.

the Revenue Act of 1916 and the Revenue Act of 1917 at the 1917 rates, as well as to the computation under the 1918 Act at the 1918 rates.[181]

LOSS FROM REBATES. Where after the close of the taxable year 1918 rebates were *bona fide* paid in pursuance of contracts entered into during such year upon sales made during such year, the net income for that year might be reduced by the deduction of the amount of such rebates actually paid. No such deduction would be allowed unless the profits from such sales had been included in the income for the taxable year 1918.[182] In cases where rebates were made on sales reported in the 1918 return of income, a separate schedule was required to be submitted and the total thereof might be included in the taxpayer's claim in abatement. This schedule should have been prepared in such manner as to reflect: (a) the date of each rebate; (b) the name and address of each party securing the benefit thereof; (c) a description of the goods; (d) the quantities; (e) the sales value of each item; and (f) the amount rebated. Rebates made during the taxable year 1919 on sales made during such year (provided the goods to which the rebate applied were included in the inventory at the close of the taxable year 1918) were considered as an adjustment of sales values in arriving at the loss on inventories for the taxable year 1918. This item could not go in the rebate claim, but the rebate might be considered in determining the sale price for the purpose of determining an *inventory* loss. It must be understood that rebates made on goods acquired and sold subsequent to the end of the taxable year 1918 could not be considered in any manner as a 1918 inventory loss.[183]

Rebates actually paid after the close of the taxable year, other than those paid in pursuance of contracts entered into during such year upon sales made during such year, were not allowable deductions.[184] Rebates made during 1919 on account of defective goods purchased in 1918 were not of the class referred to in this provision of the statute and could not, therefore, be included in a claim for abatement or refund filed under such provisions.[185] A written contract was not necessary in

[181] T. B. R. 10, T. B. 3-19-193.

[182] Reg. 45, Art. 262. This provision does not apply to rebates made in 1918 on 1917 shipments. (A. R. M. 136, T. B. 31-21-1754).

[183] I. T. S. 1919, ¶¶ 3364, 3365.

[184] A. R. M. 4, T. B. 28-19-614.

[185] O. D. 382, T. B. 4-20-705.

order that a taxpayer might take advantage of the above relief provision. It was sufficient that there should have been an oral contract or a contract implied from the usages and customs of the trade in general.[186]

Loss Where Goods Were Sold in 1919. Where goods included in the inventory at the end of the taxable year 1918 were sold during the succeeding taxable year, the loss which might be deducted from net income for the taxable year 1918 was the amount by which the value at which the goods sold were included in the inventory exceeded the actual selling price minus a reasonable allowance for selling expenses and for manufacturing expenses, if any, incurred in the taxable year 1919 and attributable to such goods.[187]

Loss Where Goods Were Not Sold in 1919. Where goods included in the inventory at the end of the taxable year 1918 were not sold during the succeeding taxable year, the loss which might be deducted from net income for the taxable year 1918 was the amount by which the net income for such year would be reduced if the inventory were redetermined and such goods taken at their market value (ignoring mere temporary fluctuations of value) at the end of the taxable year 1919.[188]

Method of Computing Loss in Inventory. Loose-leaf ledgers were recommended, whereby control could be secured of each classification or lot of goods upon which claim was to be made. Therein should have been recorded quantities and values as returned on the inventory at the close of the taxable year 1918; and there should have been recorded in summary form each day or week, the quantities sold and the values thereof, and all items of sales should have been carried forward, according to established classification adopted by the taxpayer, to the time when the quantities as reported in the inventory were accounted for. At the time of filing the return of income in 1919 the taxpayer was permitted to compute his loss from sales to that date, by deducting from the total sales a reasonable and proportionate allowance for operating or selling expense. The net result ascertained was to be deducted from the inventory value of the goods included in the 1918 inventory sold to that date, and the resultant loss brought down. The taxpayer was

186 A. R. R. 590, T. B. 31-21-1753.

187 Reg. 45, Art. 264. The Treasury Department first held that such loss could not include selling expenses, deductible during the taxable year in which the sale is made. See Telegram from Treasury Department dated March 3, 1919; I. T. S. 1919, ¶ 3276.

188 Reg. 45, Art. 265.

then to reduce the balances remaining unsold to then market value, and add the loss thus ascertained from sales. The sum total of these computations would represent the total loss upon which the amount of tax to be claimed *in abatement* should be computed and this amount was deductible from the unpaid installments of the tax, *provided*, a proper bond was furnished. Should any goods unsold, upon which claim in abatement had been filed at the time of filing the return, to be disposed of by sale at a subsequent time within the taxable year 1919, the taxpayer was to continue to record the sales effected, deducting therefrom the proportionate cost of operating or selling expense. The gain or loss would then be ascertained by computing the difference between the adjusted sales values and the inventory value established at the time of filing the claim in abatement. If at the close of the taxable year 1919 there remained any commodity unsold, the taxpayer could adjust the inventory value to the market price (ignoring mere temporary fluctuations in price or value), at the close of the taxable year and compute the amount of gain or loss. Such gain or loss would be combined with the gain or loss on sales between the time of filing the return and the close of the taxable year 1919. If it was shown that the taxpayer had sustained a loss additional to that shown in the claim in abatement a claim for refund should have been made on Form 46 for the amount of tax overpaid. Should it be shown that the amount deducted in the claim in abatement at the time of filing the return for the taxable year 1918 was in excess of the tax based upon actual losses sustained throughout the taxable year 1919, the taxpayer was required to remit to the collector the additional amount of tax involved with interest at the rate of 1% per month from the time of filing the return until the date of filing the final adjustment of taxes for the taxable year 1918 on account of inventory losses.[189]

[189] See I. T. S. 1919, ¶ 3359.

The following is an example of the computation above outlined:

Assume an inventory at December 31, 1918, 200,000 yds. at 15c.		$30,000
Assume sales, between January 1, 1919, and June 1, 1919, 100,000 yds. at 12½c.	$12,500	
Cost of manufacturing or selling based upon data ascertained from 1918 operations, say in this case of 15% of sales values	1,875	
Net proceeds from sales	$10,625	
The inventory cost at 15c per yd. amounted to	15,000	
Net loss upon which tax can be claimed in abatement		4,375

CLAIMS. Claims in abatement could be filed with the collector on Form 47 when the return for the taxable year 1918 was made. Where the taxpayer had filed his return, but the total amount of tax had not been collected, a claim in abatement was considered if filed before, or within ten days after the mailing of the collector's notice and demand on Form 17.[190] Claims for refund to cover the loss in 1918 inventory, ascertained at the close of the taxable year 1919, were required to be filed within a reasonable time. There was, however, no time limit fixed by law within which such claims must be filed (except the general statute of limitations applying to all claims for refund) and therefore, the statement emanating from the advisory board that such claims

Assume that the market price at June 1, 1919 (on the assumption that the taxpayer will prepare his claim on June 1, rather than delay until June 15, 1919), on this class of goods was 12c. There would remain unsold at that time 100,000 yds. originally inventoried at 15c to be reduced to 12c or at a loss of 3c per yd. aggregating....		3,000
Total amount upon which tax could be claimed in abatement at the time of filing the return on or before June 1, 1919, would be		$7,375
Now, between June 1, 1919, and December 31, 1919, assume that the taxpayer sells 50,000 yds. at a price of 15c per yard, amount of sale would be	7,500	
Deducting therefrom operating or selling expense at the same rate of 15% (or, if ascertainable, the adjusted percentage for 1919)	1,125	
Net proceeds from sale	$6,375	
Cost of this material as adjusted at June 1, 1919, on the basis of 12c per yd.	6,000	
Gain on these transactions	$375	
Further, assume that the remaining 50,000 yards were unsold at the close of the taxable year 1919, and that the market price had risen to 17c per yd., the taxpayer would, in this case, have to readjust his inventory value to the 17c basis, and account for the element of appreciation, in this case (5c per yd. over adjusted figure as of June 1)	2,500	
Total gains		2,875
Adjusted loss upon which tax is to be abated or refunded, as the case may be		$4,500

[190] Letter from treasury department dated August 6, 1919; I. T. S. 1921, ¶ 1627.

should be filed within thirty days after the close of the taxable year 1919, must be considered as directory and not mandatory. Each claim was required to contain a concise statement of the amount of the loss sustained and the basis upon which it had been computed, together with all pertinent facts necessary to enable the Commissioner to determine the allowability of the claim. The amount allowed by the Commissioner in respect of any such claim was deducted from the net income for the taxable year 1918 and the taxes recomputed accordingly. Any excess paid over the tax due was credited or refunded to the taxpayer. In computing income for the taxable year 1919 the opening inventory was required to be properly adjusted by the taxpayer in respect of any claim allowed for the year 1918.[191] Two claims might be filed, one at time of filing the return, and one adjusting the entire claim for losses at the close of the taxable year 1919. The first would represent a claim in abatement; the second, a claim for refund. It was possible that an additional amount of tax might become due from the taxpayer with interest at the rate of 1% per month from the time of making the deduction until the time of filing the final statement, which would be brought about by the fact that, in the disposition of unsold goods as to the 1918 inventory after the filing of the original return, and the claim in abatement, gains might result from subsequent sales. It would therefore be necessary for the taxpayer to prepare a statement which would fully reflect the corrected amount of any claim to which he might be entitled for losses in inventory of 1918, and this statement should definitely embrace the total amount of inventory value as recorded on the books of the taxpayer at the end of the taxable year 1918, and be capable of proper audit.[192] Taxpayers were required to file with the original claim and at the close of the taxable year 1919 summarized

[191] Reg. 45, Art. 266. While the law and the regulations state that claims in abatement should be filed when the return for the taxable year of 1918 is made, the treasury department has ruled that taxpayers may file a claim for abatement based on revaluation of inventories at the time of filing return, or any time thereafter during 1919. This does not preclude the taxpayer from filing an amended claim during 1919, but after one claim has been allowed, no further claim may be made. (Telegram from treasury department dated April 3, 1919; I. T. S. 1919, ¶ 3291.)

[192] I. T. S. 1921, ¶ 1636. The following is an illustration of an outline to be used in making final statement of adjustment at the close of the taxable year 1919. This is based upon the illustration given above which applies to one item of inventory only, but it must be understood that the final statement referred to herein, must cover the entire inventory value as at the end of the taxable year 1918:

statements covering all adjustments involved. To conform to good accounting practices, the taxpayer should have considered these summaries in the light of controlling accounts and the sum totals thereof should have equalled the total inventories maintained in detail by the taxpayer. Claims for losses in inventories of the taxable year 1918 should have embraced all items in the taxpayer's inventory so that gains made in any sales of certain items or classes would be used to offset losses in others and the net result as to the entire inventory determined. Thus if the final computation showed a net gain over all inventory items sold, no claim for loss in any particular item or items could be sustained.[193]

CLAIMS OF PARTNERSHIPS. A claim in abatement arising from a loss in 1918 partnership inventory was required to be made by each individual partner as to his distributive share of recomputed net income. To this claim should have been attached the statement of the partnership showing the loss in inventory supported in the same manner as such claims were supported by corporations and individuals. The statement filed as to the partnership as a whole was used by the department for the purposes of record and verification and any adjustments which might be found necessary would be spread pro rata over the claims of the individuals. At the close of the taxable year 1919 a properly authorized member of the partnership should have compiled the final statement of adjustment in accordance with

	Quantity	Value
1. Inventory close of taxable year 1918	200,000	$30,000
2. Sales from 1918 inventory during taxable year 1919	150,000	20,000
3. Less deductions from sales for selling expenses		3,000
4. Net sales proceeds (Item 2 value less Item 3)		17,000
5. Balance of 1918 inventory on hand at close of taxable year (Quantity Item 1 less Item 2) (Value priced at market close taxable year 1919)	50,000	8,500
6. Net sales proceeds and balance of inventory (Item 4 plus Item 5, values)		25,500
7. Loss (Item 1 value less Item 6)		4,500
8. Gain		......
9. Amount of claim in abatement or for refund filed		$ 7,375

In this illustration an excessive claim in abatement of tax based upon a loss of inventory values, amounting to $2,875, is assumed. Tax upon this amount with interest at one per cent per month between the date of making the deduction and final statement will be assessed in this case. Should the taxpayer elect not to file a claim in abatement at the time of filing his return, but rather to wait until the end of the taxable year 1919, then, in that case, but one claim would be filed.

[193] I. T. S. 1921, ¶ 1640; O. D. 186, T. B. 8-19-323.

the methods previously outlined, attaching thereto the proportionate amounts of adjustment affecting each individual member of the partnership. On the determination of the net result, each individual partner should have filed a claim for refund (if any refund was due), or in the event that the claim in abatement was in excess of the actual losses sustained, each individual would remit to the collector of his district, his share of the additional amount of tax ascertained from the adjusted statement, with interest at the rate of 1% per month from the original due dates of the tax.[194] Each partner was required to furnish a separate bond in the requisite amount.[195]

DISPOSITION OF CLAIMS. A claim for loss resulting from rebates paid or from actual sales could be decided as soon as practicable after it had been filed. A claim for loss in inventory not realized by sale could be decided only after the close of the taxable year 1919 upon the basis of any permanent reduction in the level of market values which had occurred during such year from the inventory values taken at the close of the taxable year 1918. Not later than thirty days after the close of the taxable year 1919 a taxpayer who had filed either a claim in abatement or a claim for refund, or both, was required to submit to the Commissioner a descriptive statement showing the quantity and kind of all goods included in the 1918 inventory which had been (a) sold at a loss in the taxable year 1919, (b) sold at a profit during the taxable year 1919, or (c) not sold or otherwise disposed of during the taxable year 1919, together with such other information in respect of such goods as the Commissioner might require. A claim filed with the return for a loss not then realized by sale was passed upon in the light of any sales thereafter made during the taxable year 1919. A claim filed with the return was authorized for the purpose of allowing the taxpayer to utilize, where justified, a preliminary allowance for inventory losses and not to provide a deduction essentially different from that taken by way of a claim filed at the end of the taxable year 1919.[196]

EFFECT OF CLAIM IN ABATEMENT. In the case of a claim in abatement filed with a return, payment of the amount of the tax covered thereby was required until the claim was decided, provided the taxpayer filed therewith a bond on form 1124 in double the amount of the tax covered by the claim, conditioned for the payment of any part of such tax found to be due with

[194] I. T. S. 1921, ¶ 1643.

[195] O. D. 218, T. B. 11-19-380.

[196] Reg. 45, Art. 267. No claim would be allowed unless the above information was fully supplied. (A. R. R. 554, T. B. 30-21-1745).

interest at the rate of 12 per cent. per annum. The filing of this bond was not a condition precedent to the consideration of the claim for abatement on its merits, but was merely a condition precedent to securing immunity from collection during the pendency of the claim. The bond was required to be executed by a surety company holding a certificate of authority from the secretary as an acceptable surety on federal bonds and was subject to the approval of the Commissioner. If abatement of any part of the tax covered by such a claim was denied, then such part was required to be paid by the taxpayer with interest at the rate of 12 per cent per annum from the original due date of the tax.[197]

LIBERTY OR OTHER BONDS AS SECURITY. In case the claimant, in accordance with the provisions contained in the Revenue Act of 1918,[198] elected to offer, in lieu of the surety or sureties provided for on Form 1124, United States Liberty bonds or other bonds of the United States as security he could execute in duplicate a bond and agreement on Form 1124a. The original was to accompany the United States bonds offered as security; the duplicate was to be forwarded by the collector with the abatement claim to the Commissioner. If such bond and agreement was executed by a corporation a duly certified copy of the resolution of the board of directors, authorizing the execution, was also required. The United States Liberty bonds or other bonds of the United States, offered as security, had to be, in par value, not less than the amount of the penal sum of the bond executed on Form 1124a, which had to be in double the amount of the tax covered by the abatement claim. The bonds so offered as security were delivered to the Commissioner at the obligor's risk and expense. Registered bonds so offered as security were registered in the name of the obligor and duly assigned to the Commissioner at or before the date of deposit with the Commissioner. The Commissioner issued a receipt in duplicate for United States bonds so deposited with him as security, the original of the receipt being given to the obligor, and the duplicate retained by the Commissioner for his files. Bonds of the United States were returned to the obligor as soon as the security for the performance of such penal bond was no longer necessary. Registered bonds were re-assigned to the owner when the liability was cancelled.[199]

[197] Reg. 45, Art. 268; A. R. R. 331, T. B. 48-20-1323.
[198] Revenue Act of 1918, ¶ 1320.
[199] T. D. 2925.

Where Liberty bonds were deposited as collateral, as provided when a claim for abatement for a loss in inventory was filed, coupons representing one year's interest might be detached from the bonds prior to depositing them as collateral on Form 1124.[200]

[200] O. D. 193, T. B. 8-19-336.

CHAPTER 26

DEDUCTION OF ALLOWANCE FOR DEPRECIATION, OBSOLESCENCE AND AMORTIZATION

The Revenue Act of 1921 has introduced no substantial changes with respect to allowances for depreciation, obsolescence and amortization. The only change in regard to depreciation deductions is a statutory enactment of the former departmental practice that depreciation deductions must be based on the fair market price or value as of March 1, 1913, of property acquired prior thereto. The amortization provision remains substantially the same, certain definite dates being inserted now that the war has been officially terminated. In the case of individuals the Revenue Act of 1921 permits a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business of an individual, including a reasonable allowance for obsolescence.[1] In the case of nonresident aliens, and certain citizens taxed as nonresident aliens,[2] the deduction for depreciation or obsolescence is permitted if and to the extent that it is connected with income arising from sources within the United States; and the proper apportionment and allocation of the deduction with respect to sources of income within and without the United States is determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.[3] In the case of corporations, the allowance is also for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence,[4] limited in the case of a foreign corporation, and certain domestic corporations taxed as foreign corporations,[5] as above indicated in the case of nonresident aliens.[6] It must be borne in mind that the allowance for depreciation or obsolescence does not include any element of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence. The proper allow-

[1] Revenue Act of 1921, § 214 (a) 8. This statutory enactment of the former departmental practice was made to remove all doubt as to whether depreciation of property acquired before March 1, 1913, should be based on cost or value on that date in view of the cases of Goodrich v. Edwards, 41 Sup. Ct. Rep. 390, and Walsh v. Brewster, 41 Sup. Ct. Rep. 392.

[2] See Revenue Act of 1921, § 262.

[3] Revenue Act of 1921, § 214 (b).

[4] Revenue Act of 1921, § 234 (a) 7.

[5] See Revenue Act of 1921, § 262.

[6] Revenue Act of 1921, § 234 (b).

ance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property, its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date.[7] The new provisions of the Revenue Act of 1918 and continued in the present law for the deduction of a reasonable allowance for obsolescence and amortization are treated in this chapter in addition to the subject of depreciation of property used in the trade or business of a taxpayer. Depreciation in the case of farmers is discussed elsewhere in this book.[8]

Depreciation Under Preceding Income Tax Laws. As pointed out in the preceding paragraph the 1918 Law contained provisions similar to those of the present law respecting depreciation, obsolescence and amortization. The 1909 Law[9] allowed the deduction of all losses including a reasonable allowance for depreciation of property, if any. The 1913 Law allowed as a deduction in the case of individuals[10] "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business," and in the case of corporations[11] all losses "including a reasonable allowance for depreciation by use, wear and tear of property, if any." The 1916 Law allowed to individuals[12] a deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade," and to corporations[13] a deduction of all losses "including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade." It is important to note the difference in phraseology between these various provisions in consulting any case decided under preceding laws as an authority under the present law.

Depreciable Property. The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this

7 Reg. 45, Art. 161.
8 See Chapter 7.
9 Act of August 5, 1909, § 38.
10 Act of October 3, 1913, § B.
11 Act of October 3, 1913, § G (b).
12 Revenue Act of 1916, §§ 5 (a), 6 (a).
13 Revenue Act of 1916, § 12.

nature.[14] In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art or to becoming inadequate to the growing needs of the business. It does not apply to inventories or to stock in trade; nor to land apart from the improvements or physical development added to it.[15] It does not apply to bodies of minerals which through the process of removal suffer depletion, other provision for this being made in the statute by way of an allowance for depletion.[16] Property kept in repair may, nevertheless, be the subject of a depreciation allowance.[17] The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business. No such allowance may be made in respect of automobiles or other vehicles used chiefly for pleasure, a building used by the taxpayer solely as his residence, nor in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business,[18] may be the subject of a depreciation allowance.[19] Since the full life of radium has been scientifically estimated at such an extended period and since no appreciable depreciation results from its continued use as a therapeutic agent, the depreciation occurring during the lifetime of any individual owner is practically negligible. It is held, therefore, that radium which is used as a therapeutic agent is not subject to depreciation and its cost must be treated as a capital expenditure.[20]

DEPRECIATION OF AUTOMOBILE USED IN BUSINESS. Depreciation may be claimed on an automobile where it can be shown that the taxpayer, in order to earn his salary, is responsible for certain duties and that the automobile is owned and used by him

[14] Deductions for depreciation may not be taken where the assets are of a more or less permanent character such as additions to the plant of a title abstract company (O. D. 1018, T. B. 36-21-1799).

[15] See paragraph on real estate below.

[16] See Chapter 28.

[17] See p. 689.

[18] See p. 682.

[19] Reg. 45, Art. 162; Reg. 33 Rev., Art. 159; T. D. 2153; T. D. 2005. Depreciation as an allowable deduction in ascertaining net incomes for the purpose of the income tax is not to be confused with the deduction for loss. See Chapters 21 and 22 as to certain expenditures which should be deducted as business expense rather than capitalized and depreciated.

[20] O. D. 837, T. B. 10-21-1496.

in the performance of such duties.[21] A member of a local draft board who used his automobile for travel on business in connection with the work of the board was not allowed to deduct any amount representing wear and tear of the automobile or maintenance expense, the automobile being used for his personal convenience and not by reason of official necessity since such members when traveling under competent orders were allowed actual traveling expenses plus a *per diem* of $4.[22]

LOSS IN RENTAL VALUE OF BUILDINGS. Under the 1916 Law and prior laws the deduction on account of depreciation could not include any allowance for an estimated loss due to lessening of rental value, nor could the computation of the deduction be influenced by the changed environment after a period of years, nor by its lack of adaptability to the use originally intended, nor to any other outside influence affecting its value. But under the present law and the 1918 Law it would seem that these factors of obsolescence may be given weight in calculating the depreciation of office buildings, apartment houses and other structures. However, the regulations appear still to hold to the old rule.[23]

REAL ESTATE. Real estate, as such, and as distinct from the improvements thereon, is not reduced in value by reason of wear and tear and an allowance for depreciation in the case of real estate does not apply to the ground. The allowance is intended to measure the decline in the value of the improvements due to the wear and tear thereof.[24] In determining the cost of real estate upon which depreciable property is located, it frequently occurs that no segregation is made of the cost of buildings as separate and distinct from the cost of the ground upon which such buildings stand. In such cases where the actual cost of the buildings or improvements at the time they were taken over by the taxpayer can not be definitely determined, it will be sufficient, for the purpose of determining the rate of depreciation to be used in computing the amount deductible from gross income, to estimate the actual value at the time acquired, of buildings or improvements if acquired after March 1, 1913, or the fair market price or value as of that date, if the property was acquired prior to March 1, 1913.[25]

LEASES. In the case of a lease held by the original lessee, who acquired it prior to March 1, 1913, without any payment

[21] A. R. R. 551, T. B. 26-21-1707.
[22] O. D. 363, T. B. 2-20-673.
[23] Cohen v. Lowe, 234 Fed. 474; Reg. 33 Rev., Art. 162; Reg. 45, Art. 166.
[24] Reg. 45, Art. 162; Reg. 33 Rev., Art. 162; T. D. 2152; T. D. 2137.
[25] Reg. 33 Rev., Art. 163; T. D. 2137; T. D. 2152.

other than a stipulated annual rent, the presumption is that the lease had no value as at March 1, 1913. Under this presumption there is no basis for a depreciation deduction. This presumption can be overcome only by evidence showing conclusively that the lease had a value as of March 1, 1913, for depreciation purposes. There is no prescribed method by which the value of a lease as of March 1, 1913, in excess of its presumptive value as at that date may be established. The burden is upon the taxpayer to establish the basis for depreciation to the satisfaction of the Commissioner.[26]

WEARING APPAREL. If costumes purchased by actors and actresses are used exclusively in the production of a play and are not adapted for occasional personal use, and are not so used, deduction may be claimed on account of such depreciation in their value as occurs during the year on account of wear and tear arising from their use in the production of a play, or a loss may be claimed if they become obsolete at the close of the production.[27] The cost of naval uniforms has been held to be a personal expense and no deduction for depreciation in their value will be allowed to naval officers.[28]

MERCHANDISE. Depreciation does not apply to inventories or to stock in trade.[29]

Intangible Property. Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in business or trade is not so limited, will not usually be a proper subject of such allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the

[26] O. D. 720, T. B. 45-20-1292.

[27] Reg. 45, Art. 162; Reg. 33 Rev., Art. 8; T. D. 2090. See Reg. 45, Art. 143, if loss is claimed.

[28] A. R. R. 594, T. B. 32-21-1761.

[29] Reg. 45, Art. 162. It has been held under previous laws that depreciation computed on total invoice cost of merchandise in stock is not an allowable deduction, except that if any portion of the merchandise in stock is unsalable by reason of obsolescence or damage, a depreciation deduction not in excess of the decline in value during the taxable year will be allowed. (Reg. 33 Rev., Art. 169.)

return or prior thereto to the satisfaction of the Commissioner.[30]

A deduction for depreciation may be taken on all such property whether acquired for cash, other property or corporate stock. The term "capital outlay" includes corporate stock.[31] Formulas are not a character of property subject to annual depreciation deductions; however, if after acquisition, a formula is found to be worthless, its cost may be charged off *in toto* in the taxpayer's return for the year in which its worthlessness was discovered.[32]

DEPRECIATION ALLOWANCE FOR PATENT OR COPYRIGHT. In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expense) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto. The allowance should be computed by an apportionment of the cost of the patent or copyright or of its fair market value as of March 1, 1913, over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or since March 1, 1913, as the case may be. If the patent or copyright was acquired from the government, its cost consists of the various government fees, cost of drawings, experimental models, attorney's fees, etc., actually paid.[33]

If a corporation purchased a patent and paid for it in stock or securities, its cost is the fair market value of the stock or securities at the time of the purchase. Depreciation of a patent can be taken on the basis of the fair market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. If the patent becomes obsolete prior to its expiration such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the date when it was acquired and the date when it legally expires may be deducted, if permission so to do is specifically secured from the Commissioner. Owing to the difficulty of allocating to a particular year the obsolescence of a patent, such permission will be granted only if affirmative and satisfactory evidence that the obsolescence occurred in the year for which the return is made is submitted to the Commissioner. The fact that

[30] Reg. 45, Art. 163; T. D. 2929; Reg. 33 Rev., Art. 162; T. D. 2152; T. D. 2137.

[31] O. D. 344, T. B. 30-19-640.

[32] A. R. R. 339, T. B. 50-20-1349.

[33] Reg. 45, Art. 167; A. R. R. 520, T. B. 44-21-1893.

depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable.[34] Where an individual has invented certain apparatus and, after securing United States patents thereon, assigned such patents to a foreign corporation under an agreement by which he retained 40% interest in profits therefrom, legal title to the patents passing to the corporation subject to the agreement mentioned and his interest being recognized by the corporation and by the United States licensees under the patents, the department has held that the agreement should be recognized as giving the individual a depreciable interest in the patents. The value of each patent as at March 1, 1913, should be segregated and the depreciation allowable thereon determined on the basis of its own life instead of using as a basis the average life of all the patents and the value of all the patents in bulk. Of the total depreciation allowable for any year, 60% is deductible in the return of the company and 40% in the individual's return.[35] An author may not value a copyright as of March 1, 1913, by estimating the future royalties for the remaining life of the copyright and capitalizing the amount of such estimated royalties.[36]

Terms of Patents and Trade-Marks. The following schedule of the terms of patents and trade-marks in various countries has been published by the treasury department for the information of taxpayers:[37]

Country.	Term of Patent.	Term of Trade-mark.
Great Britain...	16 years. Extended from 14 years by act of Parliament, 1919.	14 years renewable.
France	5, 10, or 15 years from filing of application.	15 years renewable.
Germany	15 years from next day after filing	10 years renewable.
Russia	15 years	1 to 10.
Canada	18 years	General unlimited; special 25 years renewable.
Australia	14 years	14 years renewable.
Austria	15 years	10 years renewable.
Switzerland	10 years for chemical process...... 15 years from filing..............	20 years renewable.
Sweden	15 years from filing..............	10 years renewable.
Denmark	15 years	10 years renewable.
United States...	17 years	20 years renewable.

[34] Reg. 45, Art. 167; A. R. M. 95, T. B. 47-20-1312; T. B. R. 59, T. B. 20-19-506.

[35] A. R. M. 34, T. B. 10-20-779.

[36] O. D. 966, T. B. 27-21-1721.

[37] O. D. 721, T. B. 45-20-1293. The duration of patent rights in Great Britain was extended from 14 to 16 years in 1919 (see 9, and 9 and 10, Geo. V. c. 80, Chitty, Annual Statutes 1919, p. 423). No corresponding change seems to have been made with respect to trade-marks. Important patent legislation is now pending in France which will radically change the existing law if passed. The only actual change in duration of patents and trademarks since 1909 in the countries named seems to have been in Great Britain as indicated above.

Depreciation of Drawings and Models. A taxpayer who has incurred expenses in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of the Commissioner. Except for such depreciation allowances no deduction may be made against any sum so set up as an asset except on the sale or other disposition of such assets at a loss or on proof of a total loss thereof.[38] Where no appraisal has been made on or about March 1, 1913, the value of drawings, models, tracings and patterns as of that date may be ascertained by taking the reproduction cost on March 1, 1913, determined from data in the possession of the taxpayer less depreciation from original acquisition.[39]

Capital Sum Returnable Through Depreciation Allowances. The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date.[40] In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date.[41] To this sum should be added from time to time the cost of improvements, additions, and betterments,[42] the cost of which is not deducted as an expense in the taxpayer's return, and from this sum should be deducted from time to time the

38 Reg. 45, Art. 168.

39 A. R. R. 272, T. B. 40-20-1223.

40 Revenue Act of 1921, §§ 214 (a) 8 and 234 (a) 7. It was held in early rulings that depreciation could only be claimed on the basis of cost whether or not the property was acquired prior to March 1, 1913 (T. D. 2446), but a later ruling recognized the principle of claiming depreciation on the value as of March 1, 1913, if the property was acquired prior thereto (T. D. 2754, August 23, 1918). Depreciation must be based on actual cost and not on estimated cost as shown by a contract (O. D. 1019, T. B. 36-21-1800).

41 T. D. 2754.

42 As to incidental repairs see below.

amount of any definite loss or damage sustained by the property through casualty, as distinguished from that gradual exhaustion of its utility which is the basis of the depreciation allowance. In the case of the acquisition after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition.[43] The replacement value of property can not be substituted for the cost of the property as the cost of replacement at a time some years in the future is a speculative figure which can not be used as a basis for determining an annual depreciation charge. The depreciation charge will replace the amount of the original capital outlay, which may be more or less than adequate to replace the item to which it applies. If less than adequate, new capital must be provided from surplus or otherwise to effect the replacement.[44]

Where the lessee of real property erects buildings, or makes permanent improvements which become part of the realty and income or loss has been returned by the lessor as a result thereof, the capital sum to be replaced by depreciation allowances is held to be the same as though no such buildings had been erected or such improvements made.[45] Where a corporation was liquidated and its assets transferred to a partnership organized by its stockholders, the allowance for depreciation will be based on the cost of the property to the partners. The fair market value of the assets as of the date of liquidation of the corporation will be held to be the cost of the assets to the stockholders, who as partners, turned them over to the partnership. Such fair market value as of the date of liquidation divided by the estimated life of the assets from that date will constitute the annual depreciation allowance of the partnership.[46] Where ships in process of construction under contract were requisitioned by the Shipping Board, completed, and then reconveyed to the company from which they were requisitioned for an amount in excess of the contract price of the ships, it has been held that the entire cost of the ships is a capital expenditure recoverable by allowances for depreciation, and that the excess of the cost over the contract price is not deductible as a loss or a business expense.[47]

[43] Reg. 45, Art. 164.
[44] O. D. 283, T. B. 21-19-524.
[45] Reg. 45, Art. 164, as amended by T. D. 3062, T. B. 37-20-1198.
[46] O. D. 639, T. B. 34-20-1148.
[47] O. D. 851, T. B. 12-21-1520.

Method of Computing Depreciation Allowance. The capital sum to be replaced by the depreciation allowance should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice,[48] such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return.[49] The term "useful life" is interpreted to mean the period of time over which an asset may be used for the purpose for which it was acquired. In the case of a new building, this period starts at the time the building is completed and capable of being used. Buildings under construction are not subject to a depreciation allowance for income-tax purposes.[50]

Where in 1914 the United States government took over a certain business from a corporation and held it until March, 1920, at which time it was returned to private ownership and in 1919 the government paid to the corporation a sum of money representing earnings from 1914 to April 6, 1917, and in 1920 paid a further sum as rental from April 6, 1917, to March, 1920, it has been held that as there is no authority in the law for offsetting against income received in one year losses sustained in a prior year by reason of depreciation, only such depreciation as has been sustained during the taxable periods covered by the returns may be claimed.[51]

MODIFICATION OF METHOD OF COMPUTING DEPRECIATION ALLOWANCE. If it develops that the useful life of the property has been underestimated, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. No modification of the method should be made on account of changes in the market value of the property from time to time, such as, on the one hand, loss in rental value of buildings due to deterioration of the neighborhood, or, on the other, ap-

[48] Claiming depreciation in accordance with any practice other than that of dividing the cost by the useful life of the property is first recognized in this ruling.

[49] Reg. 45,, Art. 165.

[50] O. D. 845, T. B. 11-21-1510. An interesting question is presented as to when depreciation may first be taken in the case, for instance, of a plant the construction of which extends over a long period of time. It seems clear that depreciation may be taken on any units of the plant from the moment they are put in use.

[51] O. D. 948, T. B. 24-21-1687.

preciation due to increased demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimate of the useful life of the property.[52] Inasmuch as under the provisions of the Income Tax Acts in effect prior to the Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art.[53]

Annual Allowances Measured by Life of Property. The annual allowance may be determined by dividing the cost by the probable number of years constituting the life of the property, the result being the amount which may be deducted annually. The life of the property necessarily depends upon its character, the use to which it is put and the conditions under which it is used. These elements being taken into consideration, taxpayers are expected, as a result of experience and observation, to approximate very closely the number of years constituting the life of the property.[54] If, after property has been used for a certain purpose, it is put to another use by which it deteriorates more rapidly the allowance for depreciation may be increased accordingly. In estimating the life of the property it is assumed that the owner will make such repairs and renewals as are necessary to prevent undue deterioration. In the case of a building, for instance, depreciation is to be based upon the life of the building with regard to the number of years the building will remain in a condition to be useful for the purpose for which it was constructed and is used, not merely the number of years it will stand without being condemned and torn down. In determining the life of the building it is assumed that the owner will keep it in good repair.[55]

Where a taxpayer by order of an insurance company is obliged to replace boilers, it has been held that the undepreciated cost of the old boilers, less their salvage value, may be taken as a loss for the taxable year in which the old boilers were scrapped. The available supply of timber for the taxpayer's mill in the above case is estimated to last five years. The new boilers upon exhaustion of the timber supply in that region will be worth in

[52] Reg. 45, Art. 166; Reg. 33 Rev., Art. 165.

[53] Reg. 45, Art. 166, as amended by T. D. 3061, T. B. 37-20-1192.

[54] T. D. 2152.

[55] Cohen v. Lowe, 234 Fed. 474.

a new location considerably less than the cost of removal and will, therefore, be scrapped. The cost of the new boilers, less salvage value, may be recovered by annual deductions spread over the five-year period. Proper adjustment must be made in the year the timber supply is exhausted and the mill abandoned for any overestimate of the timber supply, or on the other hand, any underestimate of the salvage value of the boilers. All bases for depreciation must be fully described in the schedules attached to the returns and the facts submitted must substantiate the depreciation claimed.[56]

INCIDENTAL REPAIRS TO PROPERTY ON WHICH DEPRECIATION IS CLAIMED. Depreciation is not to be confused with ordinary repairs. It is intended to cover the estimated lessening in value of the original property, if any, due to exhaustion, wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property in spite of ordinary current repairs.[57] Ordinary incidental repairs which keep the property in an operating condition should not be charged to depreciation reserve; their cost should be charged to expense. A building or a piece of machinery or other equipment, as a whole, may deteriorate in value and usefulness by reason of wear and tear regardless of the fact that certain minor component parts may be renewed, restored or replaced. The depreciation deduction contemplates the creation of a fund that will renew, restore or replace the original property, when it has become worn out or exhausted, regardless of the renewal and restoration of parts that may have been made in the meantime. Hence, in addition to the depreciation deduction, the expense of incidental repairs which do not add to the value of the property, but merely keep it in operating condition, and arrest deterioration, should be deducted as expense in the year in which the repairs are made.[58] Thus, the lessee of a street railway, required under the lease to return the leased property at the expiration of the lease in as good condition as when received, may not take deductions for depreciation.[59]

RENEWALS TO PROPERTY. It is possible in some instances that worn out parts of a machine or similar equipment may be renewed, one after another, until the original machine or equip-

[56] O. D. 871, T. B. 15-21-1562.

[57] San Francisco Co. v. Scott, 253 Fed. 854.

[58] Reg. 45, Art. 103. Letter from treasury department dated September 19, 1916; I. T. S. 1918, ¶ 1467; Reg. 33 Rev., Art. 131.

[59] O. D. 1014, T. B. 35-21-1794.

ment is swallowed up in the renewed parts. The machine or equipment is then in as good operating condition as it was originally. In such cases, if the cost of renewed parts is charged to operating expense, no deduction on account of depreciation should be claimed as to such machine or equipment. And on the other hand, if a reserve is set up to cover property which may be renewed or restored part by part until the whole is renewed, the cost of the renewed part should be charged to the depreciation reserve fund and not to expense.[60]

It has been held under the 1909 Law that a railway company was not entitled to deduct an amount for depreciation where by reason of repairs, renewals and replacements the company "had made good the normal amount of depreciation" and at the end of the years in question the road was in normal condition to carry on its business. It was held that the condition of the road as a whole should be looked to and while there had been depreciation in various units of the property, this depreciation was offset by the repairs, renewals and replacements which maintained the road throughout the years in question in fully as good condition and at fully as great intrinsic value as at the beginning of the respective years.[61]

ADDITIONS AND BETTERMENTS. Amounts expended in additions and betterments or for furniture and fixtures, which constitute an increase in capital investment and add to the value of the assets, are not a proper deduction as expense, but such expenditures when capitalized may be extinguished through annual depreciation deductions, which latter deductions will be computed upon the basis of the cost and probable life of the property.[62]

Rate of Depreciation. The annual allowance for depreciation, is required by law to be "reasonable." No fixed rates are prescribed. The rule which has been established contemplates that the taxpayer may determine his annual deduction by dividing the cost of the property or the fair market price or value as of March 1, 1913, if acquired prior thereto, by the probable number of years constituting its life, in the manner indicated above, the result being the amount which may be deducted annually.[63] De-

[60] Letter from treasury department dated September 19, 1916; I. T. S. 1918, ¶ 1467.

[61] Nashville, Chattanooga & St. Louis Ry. Co. v. U. S., 269 Fed. 351.

[62] Reg. 45, Art. 164; Reg. 33 Rev., Art. 132.

[63] Reg. 45, Art. 161; Reg. 33 Rev., Art. 162; T. D. 2152. A collector who told taxpayers in his district that the amount of depreciation on frame buildings was limited to 3%, and in case of brick buildings to 2%, was informed by the Commissioner that while these rates might not be far from a reason-

preciation may also be claimed in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production.[64]

DEPRECIATION OF APARTMENT HOUSES. In the case of an apartment house the court has held that where the government allowed 3% of the cost as annual depreciation, the burden was on the owner to show that this amount was too small, the court considering the rate to be reasonable in this case.[65]

DEPRECIATION OF STEAMERS. In a case involving the depreciation of a steamer, it has been conceded that 5% of the book value thereof, which would contemplate a life of 20 years, was a reasonable deduction.[66] In the case of some ships constructed during the war there seems to be a tendency to allow even a greater rate of depreciation on the theory that the useful life will be less than twenty years. Three per cent. has been held to be a reasonable allowance for depreciation of bulk freight steamships on the Great Lakes; however, when due to peculiar conditions, it can be definitely determined that the established rate of depreciation will not be sufficient to return all of the capital invested, as at the date of acquisition or March 1, 1913, whichever is later, by the time the vessel will be rendered useless, an addition to the regular rate to cover obsolescence may be allowed. The amount of this addition must be determined upon the basis of the facts in each particular case—that is, the type of the vessel in question, the fitness for possible use in other lines of transportation, and the date when it can be definitely foreseen that she will be no longer commercially useful in this particular line of traffic. This rule does not necessarily apply to steamers engaged in other lines of traffic, for the reason that there are distinct differences in the method of construction and the matter of operation of package freighters and passenger steamers and the bulk freighters under consideration.[67] The department has held that

able and fair measure of depreciation sustained on such buildings, the rates should not be considered as the "limit," as the probable number of years constituting the life of the building might make the rate more or less than the figures stated. (Letter from treasury department dated May 22, 1916; I. T. S. 1918, ¶ 1496.) It has been held in the case of a telephone company that the average life of the combined elements which make up the plant is about 14 years and that the rate of depreciation properly chargeable against the value of the plant as a whole is 7%. (Cumberland Tel. & Tel. Co. v. Louisville, 187 Fed. 637, 654.)

64 Reg. 45, Art. 165. See note 48.

65 Cohen v. Lowe, 234 Fed. 474.

66 San Francisco Co. v. Scott, 253 Fed. 854.

67 A. R. R. 27, T. B. 9-20-773.

the proper annual rate of depreciation on steam schooners engaged in the coastwise lumber trade is 5%, based upon an expected life of 20 years.[68]

EXTRAORDINARY DEPRECIATION. When delicate machinery designed for the manufacture of a certain product is used in manufacturing a product of much coarser materials for which use it is not fitted, and is operated at a heavy overload of its normal capacity, the owner is entitled to deduct from gross income an amount representing extraordinary depreciation.[69] Where physical equipment of oil wells is subjected to depreciation from sulphur water in coal mines in the immediate vicinity, it has been held that this condition is abnormal and a depreciation rate of 10% was allowed.[70]

FACTORIES RUNNING NIGHT SHIFTS. When machinery and equipment are operated more than the usual number of working hours, a greater rate of depreciation may be applied in determining the annual exhaustion, wear and tear sustained than would be permitted in the case of machinery normally operated only eight or nine hours a day. No definite rulings have been made as to the amount by which depreciation may be increased on this account. Each case is considered in connection with all the facts and figures relative thereto.[71]

Annual Allowance Must Be Charged Off on Books. A depreciation allowance, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which it shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which must be reflected in the annual balance sheet. A journal entry alone is not sufficient.[72] The allowances should be computed and charged off with express reference to specific items, units or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. The taxpayer should keep such records as to each item or unit of depreciable property as will permit the ready verification of the factors used in computing the allowance for

68 A. R. R. 279, T. B. 42-20-1245.

69 A. R. R. 45, T. B. 16-20-862.

70 A. R. R. 570, T. B. 37-21-1818.

71 Letter from treasury department dated July 12, 1918; I. T. S. 1921, ¶ 1486.

72 Letter from treasury department dated May 18, 1916; I. T. S. 1918, ¶ 1591.

each year for each item, unit or group.[73] This charging off of the depreciation allowance is required in order to insure that the returns of the taxpayer are in accord with his books of account and in order that error and fraud with respect to the facts may be prevented. The statute is not, however, to be considered as requiring that depreciation, depletion and other losses be charged off within the taxable year. It is sufficient that they are charged off before they are allowed as deductions. Consequently the taxpayer may at any time reopen his books and charge off depreciation which he actually sustained during the taxable year. If the books are reopened for this purpose, corresponding corrections must be made in the other book entries and if for any reason the facts do not warrant such other charges it will be held that the depreciation can not be charged off and therefore can not be allowed as a deduction. For example, if by reason of a distribution of earnings there is nothing from which to credit a reserve for depreciation no allowance for depreciation can be credited to a depreciation reserve account.[74] It has been held, however, that in computing the taxable net income of

[73] Reg. 45, Art. 169; letter from treasury department dated September 19, 1916; I. T. S. 1918, ¶ 1467; Reg. 33, Art. 130; Reg. 33 Rev., Art. 159; letter from treasury department dated February 12, 1915; I. T. S. 1918, ¶ 1526. Neither the 1909 Law nor the 1913 Law required that in order to secure a deduction for depreciation the amount claimed should be written off. It was, nevertheless, held by the treasury department that a depreciation deduction, in order to be allowable must be so entered upon the books of a corporation as to constitute a liability against its assets. (Letter to collectors dated August 27, 1914; I. T. S. 1918, ¶ 1483.) In a later ruling it was held that, under these acts the writing off of depreciation would not be insisted upon in the adjustment of returns filed for the years 1909 to 1915 inclusive. (T. D. 2481, dated April 10, 1917.) In the meantime the courts had held, under the 1909 Law, that the contention that no allowance for depreciation could be claimed unless entered on the books of the company, recorded from time to time, was without force (U. S. v. Nipissing Mines Co., 202 Fed. 803 reversed in part on jurisdictional grounds, 206 Fed. 431) and that the fact that a deduction was incorrectly carried on the books in surplus account did not justify the government in disallowing it. (Forty-Fort Coal Co. v. Kirkendall, 233 Fed. 704.) The Supreme Court of the United States declined, in Strattons' Independence v. Howbert, (231 U. S. 399) to answer the question as to whether or not a book entry was necessary, since the question was not properly brought before the court in that case.

[74] Letter from treasury department dated June 25, 1919; I. T. S. 1918, ¶ 2115; A. R. R. 377, T. B. 5-21-1415. The 1916 Law did not expressly require individuals to enter on their books the annual allowance for depreciation but with respect to domestic corporations it expressly provided that all losses, including the allowance for depreciation, must be "charged off" within the year. Revenue Act of 1916, §§ 5 (a), 6 (a), 12 (a), 12 (b). As to foreign corporations the law was silent.

a corporation, it can not be denied a deduction on account of depreciation actually sustained and charged off, even though after paying dividends there remains an amount of surplus and earnings insufficient to cover depreciation; and that in such case the book value of the assets must be reduced by an amount equal to the difference between the amount of the depreciation actually sustained and charged off and the amount of the earnings and surplus available for depreciation at the end of the taxable period.[75]

Reserves for Depreciation. In early rulings it was held that depreciation set up on the books and deducted from gross income could not be used for any purpose other than making good the loss sustained by reason of the wear and tear or exhaustion of the property; and that if any portion of the depreciation set up was diverted to any purpose other than making good the loss sustained by reason of such depreciation the amount would be disallowed. It was also held that the investment of depreciation reserve funds in additions, betterments and improvements was not contemplated by the law.[76] The present ruling holds that the allowance for depreciation is to be credited to an appropriate reserve account and be carried as a liability against the assets, to the end that when the total of these credits equals the capital investment account no further deductions will be allowed. There is no requirement of law that the funds represented by these reserve liabilities shall be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed, or in restoring the capital investment in the depleted assets. The depreciation reserve may be invested in assets of any kind.[77]

Closing Depreciation Account as to Any Item. If the use of any property in the business is permanently discontinued, although no sale or other disposition of the property has taken

[75] A. R. M. 112, T. B. 10-21-1497.

[76] Reg. 33, Arts. 132 and 133; T. D. 2137.

[77] T. D. 2481. It was stated in Revised Regulations No. 33 as follows: "Depreciation set up on the books and deducted from gross income can not be used for any purposes other than in making good the loss sustained by reason of the wear and tear of the property with respect to which it is claimed. If, however, an investment is made in extensions, additions, or betterments of the company's own property, representing a part or the whole of the credit balance of the depreciation reserve account, such investment will not be considered a misuse or diversion of the depreciation deduction otherwise allowable." (Reg. 33 Rev., Art. 164.) The language used in the text above seems, however, to be a sounder statement of the law.

place, a determination of any gain or loss may be made; but any deduction in respect of any loss thereon must be disclosed in the taxpayer's return for the year in which the determination is made and a full statement of the facts and the basis upon which the computation is calculated must be attached to the return. Upon a sale or other disposition of the property, the consideration received should be compared with the amount of the estimated salvage value used in computing the gain or loss as above provided, and the amount of the difference should be treated as a gain or loss, as the case may be, of the year in which the sale or other disposition took place.[78] Where a taxpayer engaged in distilling has claimed a deduction for loss in 1917 due to the abandonment of the business through operation of law, part of such loss being disallowed by the department but a subsequent sale in 1918 conclusively establishing the reasonableness of the deduction, it has been ruled that the taxpayer may be allowed to deduct for 1917 the amount claimed, his 1918 deduction being correspondingly reduced.[79]

Obsolescence. The Revenue Act of 1921, like the former law, provides that the deduction permitted to individuals or corporations for the exhaustion, wear and tear of property used in trade or business, may include "a reasonable allowance for *obsolescence*."[80] Obsolescence is that loss which occurs in respect of tangible property from the changes due to the normal progress of the art in which such property may be used, or to becoming inadequate to the growing needs of the business.[81] This definition, however, seems to be incomplete and does not take into consideration classes of property such as buildings, which may become obsolete for the purposes for which they were erected. A taxpayer who in computing depreciation allowances in returns for years prior to 1918 has not taken ordinary obsolescence into consideration may, for the year 1918 and subsequent years, revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art or the growing needs of the business.[82]

78 Reg. 45, Art. 170.

79 A. R. R. 93, T. B. 19-20-919.

80 Revenue Act of 1921, §§ 214 (a) 8 and 234 (a) 7; Revenue Act of 1918, §§ 214 (a) 8 and 234 (a) 7.

81 Reg. 45, Art. 162. See Chapter 25 for a discussion of "Loss of Useful Value."

82 Reg. 45, Art. 166.

No amount may be charged off in any year in anticipation of obsolescence of a building which *may* become obsolete 5 or 10 years later. However, a certain amount of obsolescence may be claimed from the time that it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence should be, approximately, the difference between the fair market value of the building as of March 1, 1913, or its cost if acquired after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete and should be claimed in those years. For instance, the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918, was represented by $18,000, and its estimated salvage value will be $5,000 in 1920. At that time (December 31, 1918) it was definitely determined and certain that in 1920 the building would have to be torn down and rebuilt, due to its inadequacy to meet the growing needs of the industry it housed. The difference between the depreciated value December 31, 1918, namely, $18,000, and its estimated salvage value of $5,000, represents obsolescence. This amount of $13,000 should be spread over the years covering the period 1919 and 1920 and deductions claimed accordingly for those years. In cases where obsolescence is claimed it must be supported by facts which will enable the Commissioner to determine whether such claim is proper and allowable.[83]

It has been held that a shipbuilding company is not entitled to a deduction for obsolescence of its plant where it sells such plant at less than its book value because of failure to obtain shipbuilding contracts. In the case in which this ruling was made, the company had owned shipbuilding plants for many years and during 1917 and 1918 had greatly enlarged its plants for the purpose of building ships for the United States Shipping Board. After the war the company found itself unable to obtain contracts and sold its plants at a loss. Proper allowance had been taken in its returns for amortization of its war facilities. The loss actually sustained should be deducted as a loss arising from sale and would be reflected in the company's return for the taxable year in which the property was sold.[84]

[83] O. D. 381, T. B. 4-20-704.
[84] O. D. 753, T. B. 51-20-1353.

In 1910 the docks and the larger harbors along the Great Lakes were greatly enlarged and improved so that only vessels of 10,000 tons capacity or larger could be conveniently or economically accommodated. As a result of this condition the larger and newer type of vessels could carry freight at a cheaper rate than the 5,000 ton vessels previously generally in use and began at that time to displace the smaller types. A great number of these smaller vessels built in 1910 were abandoned by the end of 1921. Their salvage value was estimated at 20%. Since prior to the Act of 1918, there was no provision in the Income Tax Acts for deduction on account of loss due to obsolescence and obsolescence was only taken care of by an allowance for "loss of useful value" deductible only in the year in which the property was sold or permanently abandoned, it has been held that any loss on the 5,000 ton vessels due to obsolescence should be spread over the period from 1910 to the date of abandonment and that only that portion of such obsolescence which accrued subsequent to January 1, 1918, can be taken in returns for 1918 and subsequent years. Any further loss not taken care of by depreciation and obsolescence and not compensated for by insurance or otherwise, may be taken in the year in which the vessels are sold or scrapped.[85]

OBSOLESCENCE UNDER 1916 LAW. The position taken by the treasury department under the 1916 Law was that obsolescence was not contemplated by the provision of the law relating to depreciation, and that no other provision of the law permitted an annual allowance with respect thereto, since neither the time when property may become obsolete nor the loss when the stage of obsolescence is reached, can be determined in advance with any degree of certainty.[86] The deduction for depreciation was limited to the creation of a reserve fund, out of which the loss due to use, wear, and tear might be compensated. It was not considered possible to determine in advance when a piece of machinery, equipment or even a building would become obsolete

[85] Sol. Op. 114, T. B. 31-21-1752.

[86] In earlier rulings, the treasury department held that depreciation applied to intangible property, subject to wear and tear, exhaustion or obsolescence (Reg. 33, Art. 129; T. D. 2005; T. D. 2077; T. D. 2090). In San Francisco Co. v. Scott, 253 Fed. 854, a case arising under the 1909 Law, which permitted the deduction of "losses * * * including a reasonable allowance for depreciation, if any," the court held that depreciation, as used in that law, was intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay or gradual decline from natural causes, inadequacy, and "obsolescence."

and the treasury department held that since obsolescence could not be anticipated, an annual deduction would not be permitted to provide therefor.[87] Losses on account of obsolescence of physical property were permitted under the 1916 Law, however, as a deduction under the heading of loss, provided their amount had been recorded in the books following the condemnation and withdrawal from use of the obsolete property. The amount of obsolescence was ascertained by deducting from the cost of the property the sum of (a) the total amount that had been previously deducted on account of the depreciation of the property, and (b) its residuary value at the time of obsolescence, or (c) the amount received from the sale of the property. The obsolescence deduction could not include the accumulated depreciation applicable to prior years.[88] If no depreciation had been charged off on account of the property in respect of which obsolescence was claimed from the gross income of prior years, the amount allowable as a deduction for the year in which the property became obsolete was ascertained by deducting from the cost of the property the sum of (a) its residuary value and (b) an amount equal to the depreciation actually sustained during the prior period, which might have been deducted when computed at the rate applicable to the same or similar property. The amount of depreciation thus arrived at, as applicable to former years, might be made the basis of amended returns, and a claim for a refund of taxes overpaid, by reason of the fact that no depreciation deduction was claimed in such years, might be made.[89]

Obsolescence of Intangible Property. Obsolescence is not ordinarily applicable in the case of intangibles, but will be allowed in exceptional cases, as in the case of the discontinuance of a going business because of the exhaustion of its source of supply, where the cost of the good will, or its value as of March 1, 1913, if acquired prior to that date, can be definitely shown and the period of its obsolescence determined with reasonable accuracy. To sustain a claim for deduction for obsolescence of good will, it must be shown that the good will will be of no value at the close of an approximately definite period, and that the taxpayer will be forced to discontinue the business and be unable to continue in any similar business. An allowance for obsolescence of good will will be made only in connection with such good

[87] Letter from treasury department dated September 19, 1916; I. T. S. 1918, ¶ 1467.

[88] Reg. 33 Rev., Art. 178.

[89] Reg. 33 Rev., Arts. 162 and 179.

will as is assignable, as distinguished from good will attaching to individuals owning or conducting a business, or to the premises at which it is or was conducted; and no allowance for obsolescence will be granted in any case where, in connection with the operation of the business, the good will will be valuable in another business after the termination of the business in which the taxpayer is engaged. A corporation engaged in the business of sampling ores is entitled to a deduction for obsolescence not only of its plant and equipment, but for value of good will existing and having a definitely established value as of March 1, 1913, or acquired thereafter by capital outlay, if it can be shown that the plant and equipment will be useless and the good will of no value at the close of an approximately definite period by reason of exhaustion of the ores on which its business depends.[90] An inventor of a war device, which undoubtedly had a large value on January 1, 1918, when the war was on in full force, has been held not entitled to claim a deduction for depreciation and obsolescence based on the value of the intangible property as of that date and on December 31, 1918, after the signing of the armistice, when it is claimed it had a very small value.[91]

Obsolescence in the Case of Distillers, Dealers in Liquor, etc. It was first ruled by the treasury department that a reasonable allowance for obsolescence of good will, trade-marks and trade brands, the value of which has been impaired or destroyed by prohibition legislation, might be taken by distillers and dealers in liquor against earnings between November 21, 1918, the date upon which the Agricultural Appropriation Act, providing for war-time prohibition was enacted, and July 1, 1919, the date upon which war-time prohibition became effective. The latter date was subsequently changed to January 16, 1920, as stated below. To sustain a claim for a deduction for obsolescence in respect of good will, trade-marks, or trade brands, the taxpayer must show

[90] O. D. 472, T. B. 17-20-884.

[91] T. B. M. 39, T. B. 7-19-291. It is not clear whether obsolescence was disallowed in this case on the ground that the cost of the patents, or their fair market value on March 1, 1913, did not exceed their value at the end of 1918, their value having merely appreciated during the war, or on the ground that the ending of the war failed definitely to prove their obsolescence. It would seem that obsolescence of patents should be allowed in many cases as a result of the ending of the war if it can be definitely shown that as a result thereof substantial contracts were cancelled or the patents otherwise lost their value in whole or in part at the time of the armistice. In other words, while the ending of the war might not *per se* constitute sufficiently tangible proof of the obsolescence, there might well be accompanying circumstances which would prove obsolescence beyond any doubt.

that the value of the property in question was destroyed not later than June 30, 1919, and that he is not continuing in any similar trade or business. An allowance will be made only in respect of such assets as are assignable as distinguished from those attaching to the individuals owning or conducting the business or to the premises at which it is being or has been conducted. No allowance for obsolescence will be made in any case where, in connection with the operation of his previous business, the taxpayer has developed a good will, trade-mark, or trade brand that is valuable in continuing a lawful business after June 30, 1919.[92]

An allowance for obsolescence of intangible assets (trade-marks, trade brands, etc.) of a corporation engaged in the wholesale and retail liquor business will not be permitted in 1917 if the corporation had a considerable volume of sales in 1918 showing that the intangible assets had some value on December 31, 1917, even though they may have shrunk considerably in value by that date.[93] Deductions from gross income on account of depreciation or obsolescence of intangibles, such as good will, trade-marks, and trade brands, allowed distillers and dealers in liquors, are also applicable to brewers.[94] Property consisting of a plant, including equipment for the manufacture of beer bottles, which because of restrictions and regulations by the United States government on the brewery industry can not be sold and in consequence the factory had to be closed, has, to the extent the property or plant was constructed for the manufacture of beer bottles and is not suited or adapted for any other purpose without reconstruction, become obsolete. The corporation to that extent is entitled to a deduction for obsolescence. So much of the shrinkage in value of the plant, if any, as is not thus due to obsolescence can not be claimed as a deduction for loss until the property is sold or becomes worthless and the loss is definitely ascertained.[95]

The values will be based on those as at March 1, 1913, if the good will, trade-marks, or trade brands were acquired or established prior to that date, or at the actual cost thereof, if acquired subsequent to February 28, 1913. Information helpful in establishing the values would be of the following general character: A. Where the good will, trade-marks, or trade brands were acquired prior to March 1, 1913: (1) The nature of business (whether distillers, wholesalers, or retailers, or a combination

[92] O. D. 818, T. B. 8-21-1465; O. D. 1001, T. B. 34-21-1780.
[93] A. R. R. 185, T. B. 29-20-1076.
[94] O. D. 298, T. B. 24-19-565.
[95] O. D. 125, T. B. 3-19-190.

thereof). (2) Date of foundation of business and whether organized as an individual, partnership, or corporation. Also date and particulars of each change in the ownership or form of organization of the business, such as the admission or retirement of a partner or partners; the incorporation of a company and of each reorganization thereof. (3) In respect to the trade-marks or trade brands for which a deduction is claimed: (a) The date established and by whom. (b) The date of acquisition by the present owners. (c) The price paid therefor and whether paid in cash or stock; if the latter, state the basis of the valuation on which the purchase price was determined. (d) For each year from 1900 or the date of the establishment of the trade-mark or trade brand, if subsequent to that year, to 1919, inclusive: (I) Annual sales (quantity and amount). (II) The gross profit on sales (i. e., the difference between the selling price and the cost price of the merchandise sold). (III) The total expenses and losses of the business which, when deducted from the gross profit on sales, will produce—(IV) The net income. Where the records permit, the sales and gross profit on sales should be submitted for each class of merchandise sold and, if possible, for each trade-mark or trade brand in respect of which a deduction is claimed. (V) The amount of capital invested in the business (i. e., capital or capital stock and paid in or earned surplus and undivided profits) as at the beginning of each year. (VI) The amount included in the invested capital at the beginning of the period in respect of good will, trade-marks, or trade brands and the date and amount of each subsequent addition to the good will, trade-marks, or trade brands. (e) Full details of each offer to purchase any of the trade-marks or trade brands, setting forth in particular the date of each offer, by whom and on whose behalf made: the amount of each offer, and whether payable in cash or stock; and the date or dates on which the purchase price was proposed to be paid, and the amounts to be paid on each such date. (4) Where a deduction is claimed in respect of good will, as distinct from trade-marks or trade brands, the following information should be submitted: (a) The date of acquisition, and from whom acquired. (b) The amount paid therefor and whether paid in cash or in stock. If the latter, state the basis of the valuation on which the purchase price was arrived at. (c) For each year from 1900 or the date of acquisition, if subsequent to that year, to 1919, inclusive. (I) The annual sales of the business (quantity and amount) classified, if possible, as to the various kinds of merchandise sold. (II) Gross profit on each class of merchandise sold, or if the records do not disclose the information, the gross

profit of the business as a whole. (III) Total yearly expenses and losses of the business which, when deducted from the gross profit on sales, will produce—(IV) The net income from the business. (V) The amount of capital invested in the business (i. e., capital or capital stock and paid in or earned surplus and undivided profits), as at the beginning of each year. (VI) The amount included in invested capital at the beginning of the period in respect of good will and the date and amount of each subsequent addition to good will, trade-marks or trade brands. (d) Full details of each offer to purchase the good will, setting forth in particular the date of each offer; by whom and in whose behalf made; the amount of each offer and whether payable in cash or in stock, and the date or dates on which the purchase price was proposed to be paid, and if on more than one date, the amount payable on each such date. B. Where good will, trade-marks or trade brands were acquired subsequent to February 28, 1913: (1) Dates of acquisition of good will or of each trade-mark or trade brand. (2) From whom acquired. (3) Purchase price of good will or of each trade-mark or trade brand. (4) Whether purchased for cash or stock; if the latter, state the basis of the valuation on which the purchase price was arrived at. Similar information to that suggested in A—3d, and 3e, and in A—4 should also be furnished for each of the five years prior to the date of acquisition, and for each year thereafter up to and including the year 1919. C. In the case of good will, trade-marks and trade brands acquired prior to March 1, 1913, a statement should be submitted showing the development of prohibition and local option laws within the territory of the taxpayer during the five years preceding March 1, 1913. Such statement should show each prohibition or local option law enacted by any state or other governmental unit within the business territory of the taxpayer, and should also state the unsuccessful efforts at such legislation during such period.[96]

An extension of the period set forth above against the earnings of which the obsolescence might be taken as a deduction was later granted and the treasury department has now ruled that in arriving at the taxable income for the first taxable year ending on or after January 31, 1918, the obsolescence fully accrued on that date is to be allowed as a deduction in computing the income subject to taxation under the Revenue Act of 1918, plus a further deduction of such proportion of the remaining value of

[96] Letter from treasury department dated June 21, 1919; I. T. S. 1921, ¶ 1461.

the intangible assets as the interval between January 31, 1918, and the end of the taxable year bears to the total interval between January 31, 1918, and January 16, 1920, (unless at an earlier date the taxpayer discontinues his business, in which case such earlier date will mark the close of the period), and that for any taxable year following the taxable year just referred to a deduction in respect of the value of such intangible assets on January 31, 1918, based upon a ratable distribution will be permissible. It is the opinion of the treasury department that the ratification of the eighteenth amendment in the month of January, 1918, by the states of Massachusetts, Maryland, and Kentucky, was the first definite indication that the prohibition amendment would be ratified by the requisite number of state legislatures, and therefore that on January 31, 1918, a computable portion of the cost of good will, trade-marks, trade brands, or the value thereof, on March 1, 1913, if acquired prior thereto (excluding any intangibles acquired since that date, the expenditures of which were deductible and had been deducted in computing income for tax purposes) had become obsolescent. On January 31, 1918, the intangible assets had an actual value, viz.: the then present value of the income to be derived therefrom between that date and January 16, 1920, or at an earlier date should the taxpayer discontinue his business prior thereto. This value as stated above should be distributed ratably over the period from January 31, 1918, to January 16, 1920 (unless at an earlier date the taxpayer discontinues his business, in which case such earlier date will mark the close of the period). The excess of the cost of the intangibles or the value thereof, on March 1, 1913, if acquired prior thereto (subject to the exclusions mentioned above), over the value thereof, as of January 31, 1918, determined as outlined above, will represent the amount of obsolescence that was fully accrued on January 31, 1918.[97]

Obsolescence of Vineyards. Where vineyards planted to wine grapes appear to be rendered useless for profitable operation as vineyards through the enactment of prohibition legislation, but the owners continue to cultivate them in the hope that some new and profitable use for the crop may be found, a reasonable deduction for obsolescence may be claimed. There being at the time this ruling was made no data available upon which a determination of what constitutes a reasonable deduction may be made, a tentative deduction of one-half the loss which would re-

[97] Letter from treasury department dated August 19, 1919; I. T. S. 1921, ¶ 1468; T. B. R. 44, T. B. 15-19-445.

sult from the total abandonment of the property for vineyard purposes was allowed in the return for the year in which the legislation was enacted, subject to adjustment when the success or failure of the experiment shall have been satisfactorily established. Where vineyards devoted to the growing of wine grapes are, as a result of prohibition legislation, abandoned as vineyards and the vines and improvements incidental solely to grape growing are junked and the land employed in other uses, the loss directly resulting may be deducted in determining the net income of the owner, care being taken to exclude from the deduction the value of any improvements, such as installation of drainage or irrigation, fencing, breaking up of the soil, and similar improvements which, while incidental to the planting of the vineyard, tend to permanently improve the ground for other uses. The allowance for obsolescence will be distributed over the period elapsing between the passage of the prohibition measure and the date when abandonment occurs. In general, no deduction for obsolescence or obsoleteness is allowable in the case of land, but in exceptional cases, where the loss of usefulness through prohibition legislation is so great that the land practically becomes worthless, the taxpayer may, upon proper showing, be allowed a reasonable reduction on that account for the land as well as for the vines and improvements. In this case the cost or value used as the basis of such deduction for obsolescence or obsoleteness may properly include the value of any improvements which when made were regarded as permanently improving the land and which have not heretofore been charged off as expenses. In the case where the entire deduction is claimed in a single year by reason of actual abandonment on account of obsolescence of land, vines, and improvements, the amount of such deduction will be the difference between the value on March 1, 1913, if acquired prior to that date, or the cost, if acquired on or after that date, and the salvage or junk value, taking into account any deductions or obsolescence previously allowed. Where a reasonable allowance for obsolescence is claimed before actual abandonment, to be spread over a period of two or more years, care must be taken to eliminate from the sum used as the basis of the allowance any general decrease in the value of real estate due to other causes, such decrease being deductible only when definitely determined through sale. Any return of income from vineyard property in which a deduction is claimed as a result of obsolescence must be accompanied by an affidavit setting forth fully the

facts necessary to a determination of the loss properly chargeable to obsolescence under the rules above stated.[98]

Amortization. The 1916 Law made no provision for amortization of plants or equipment acquired for government contract work. That law allowed the taxpayer only ordinary depreciation due to exhaustion, wear and tear, without considering the elements of amortization or obsolescence.[99] The Revenue Act of 1918, however, provided that, (a) in the case of buildings, machinery, equipment or other facilities constructed, erected, installed or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war with Germany, and (b) in the case of vessels constructed or acquired on or after April 6, 1917, for the transportation of articles or men contributing to the prosecution of the war with Germany, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer. This allowance might not again include any amount otherwise allowed under the Revenue Act of 1918 or previous laws as a deduction in computing net income. At any time within three years after the termination of the recent war with Germany, as fixed by proclamation of the President, the Commissioner might, and at the request of the taxpayer was obliged to, re-examine the return and if he then found, as a result of the appraisal or from other evidence, that the deduction originally allowed for amortization was incorrect, the income tax and war-profits and excess-profits taxes for the year or years affected, was required to be redetermined, and the amount of tax upon such redetermination, if any, paid upon notice and demand by the collector. The amount of tax overpaid, if any, was required to be credited or refunded to the taxpayer.[100] The 1921 Law contains the same provision except that the deduction will be

[98] O. 862, T. B. 8-19-320, modifying O. D. 102, T. B. 2-19-150, and superseding T. B. M. 18, T. B. 4-19-219.

[99] Letter from treasury department dated January 4, 1919; I. T. S. 1918, ¶ 3716. See p. 697 for a discussion of obsolescence under the 1916 Law.

[100] Revenue Act of 1918, §§ 214 (a) 9, 234 (a) 8. The Committee on Appeals and Review is of the opinion that Congress in using the phrase "at any time within three years after the termination of the present war" intended to place a limitation only upon the latest date before which the contemplated redetermination must be made and that it was not the purpose of Congress to place a limitation upon the *earliest* date at which such redetermination might be undertaken. Taxpayers, therefore, need not await the formal termination of the war, but may present to the Commissioner their claim for a redetermination at any time prior to three years after such termination. (A. R. M. 10, T. B. 31-19-646.)

allowed "for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921)", and the words "before March 31, 1924" are inserted in place of the words "within three years after the termination of the present war." The rulings indicated in the following paragraphs were made under the amortization provision of the 1918 Law, and should be followed under the present law.

Claims Must Be Differentiated in Return. Claims for amortization must be unmistakably differentiated in the return from all other claims for wear, tear, obsolescence, and loss. No such claim will be allowed unless it is reflected in any accounts submitted by the taxpayer to stockholders and in any credit statements by the taxpayer to banks, and is given full effect on his financial books of account. If government or other contracts taken by the taxpayer contained recognition of amortization as an element in the cost of production, copies of such contracts must be filed with the taxpayer's return, together with a statement and description of any sums received on account of amortization and the basis upon which they were determined.

Effect Upon Invested Capital. In any case in which an allowance has been made for amortization of cost, the taxpayer will not be allowed to restore to his invested capital for the purpose of the excess-profits tax any portion of the amount covered by such allowance.[101] Where a taxpayer in filing his returns for the years 1916 and 1917, claimed a deduction for amortization to the same extent as claimed in his Munition Manufacturers' Tax returns and was allowed this deduction by the department, it has been held that he might file amended returns for the years affected, excluding therefrom as deductions the charges for amortization as originally filed and that the deductions thus excluded might be allowed as additions to the invested capital of the taxpayer.[102]

Scope of Provision for Amortization. All allowances made to a taxpayer by a contracting department of the government, or by any other contractor, for amortization or fall in the value of property, whether such allowances were made as a part of the price of the product or in settlement of claims arising out of the cancellation or termination of contracts, must be included in gross income. All payments arising out of the settlement of such

[101] Reg. 45, Art. 186. For definition of the term "government contract" see Reg. 45, Art. 1510, and Chapter 43.

[102] A. R. R. 349, T. B. 52-20-1367.

claims must be included in the accrued income of the taxable year in which such cancellation or termination (whether formal or informal) occurred. The amount of amortization to be allowed as a deduction from gross income, for the purpose of the tax, should be computed in accordance with the rule set forth in this and the following paragraphs, pursuant to which the deduction must be made, and not upon the basis of any amounts contractually or otherwise determined.[103]

DEPRECIATION OF AMORTIZED PROPERTY. The allowance for amortization will be inclusive of all depreciation during the amortization period on property subject to amortization. Depreciation will be allowed, beginning at the close of the amortization period, upon property the cost of which has been partly amortized. Depreciation on partly amortized property will be based on the value of such property after the amortization allowance has been deducted. Property which has been amortized to its scrap value will not further be subject to depreciation.[104]

PROPERTY THE COST OF WHICH MAY BE AMORTIZED. The taxpayer may deduct from gross income a reasonable allowance for amortization; such deduction not to be in excess of the cost of buildings, machinery, equipment, or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the recent war, or of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the recent war. In the case of property the construction, erection, installation or acquisition of which was commenced before April 6, 1917, and completed subsequent to that date, amortization will be allowed with respect only to that part of the cost incurred on or after April 6, 1917, and which was properly entered on the books of the taxpayer on or after that date.[105] Machinery, equipment or other facilities erected or acquired on or after April 6, 1917, for the production or manufacture of sugar are considered as contributing to the prosecution of the war and the cost may, therefore, be amortized.[106] A claim for amortization on additional facilities acquired and built by a railroad subsequent to April 6, 1917, to meet the additional demands upon such road arising out of the prosecution of the war has been denied on the ground that it was not within the pro-

103 Reg. 45, Art. 181, as amended by T. D. 3123, T. B. 6-21-1439.
104 Reg. 45, Art. 182, as amended by T. D. 3123, T. B. 6-21-1439.
105 Reg. 45, Art. 183, as amended by T. D. 3123, T. B. 6-21-1439.
106 O. D. 259, T. B. 16-19-464.

vision of the 1918 Law.[107] Yet the word "facilities" is very broad, unless it is limited as a general term to the same class as the special terms immediately preceding.[108] The term "articles contributing to the prosecution" of the war is also very general. Rulings made by the War Industries Board should be helpful in determining whether articles fell within this classification.

COST WHICH MAY BE AMORTIZED. The total amount subject to amortization will be the difference between the original cost of the property if constructed, erected, installed or acquired on or after April 6, 1917; or if acquired partly before and partly after April 6, 1917, then that part of the cost incurred on or after April 6, 1917, and properly entered on the books of the taxpayer on or after that date, less any amounts deducted for depreciation, losses, etc., prior to January 1, 1918, and the value of the property on either of the bases indicated below:

1. In the case of property useful to the taxpayer only during the period of its operation as a war facility and which has been sold or permanently discarded, or which will be sold or permanently discarded before March 3, 1924, the value will be the actual sale price or estimated fair market value as of the date when the property was or will be permanently discarded, such fair market value to be re-established at and as of the time of the investigation by engineers of the Bureau of Internal Revenue.

2. In the case of property not included in (1) above, the value will be the estimated value to the taxpayer in terms of its actual use or employment in his going business; such value to be not less than the sale or salvage value of the property: *Provided, however,* That for the purposes of returns made in 1919, the preliminary estimate of the amount of such amortization shall not, in any case, have exceeded 25% of the cost of the property. In the determination, by engineers of the Bureau of Internal Revenue, of the proper amortization allowance, the estimated value to the taxpayer of the property in terms of its actual use or employment in his going business, will be as of the time of such determination. In the final determination, the amount of the amortization allowance will be ascertained upon the basis of stable post war conditions under regulations to be promulgated when these conditions become apparent.

Special record of all property falling in (1) above, must be pre-

[107] L. O. 1074, T. B. 45-21-1909. Congress recognized that the language first used was not broad enough to embrace transportation facilities and broadened the section only in so far as to include vessels (Report of Senate Committee on Finance, dated December 6, 1918).

[108] See Chapter 47.

served by the taxpayer, and the Commissioner must be promptly notified (*a*) if, after having been in good faith permanently discarded or dismantled, property shall in any case be restored to use because of conditions not foreseen or anticipated at the time it was discarded; or (*b*) of the selling price, if sold.[109]

[109] Reg. 45, Art. 184, as amended by T. D. 2859 and further amended by T. D. 3123, T. B. 6-21-1439. It is to be noted that the original ruling of the treasury department in this connection read as follows: "The total amount to be extinguished by amortization is the difference between the original cost to the taxpayer of the property and its value to the taxpayer at the close of the amortization period (a) for sale or (b) for use, immediate or prospective, as part of the plant or equipment of a going business, whichever value is the larger, less any amounts otherwise deducted or deductible for wear, tear, obsolescence and loss. In the case of property constructed or the installation of which was commenced before April 6, 1917, and completed subsequent to that date amortization will be allowed with respect only to the cost incurred on or after April 6, 1917." It was then ruled: "In the case of other property the basis is the estimated reproduction cost as of April, 1919, of such property in its then condition. In the final determination such cost will be ascertained under stable postwar conditions, without reference to such date." The present regulation, as well as the regulation as promulgated by T. D. 2859, more justly carries out the intent of the statute to allow a deduction because of expenditures made during war time which would not have been made under peace conditions, for the reason that the normal business of the taxpayer would not have required increased facilities. Senator Simmons in discussing this provision in the senate, February 11, 1919, said: "I can answer the senator generally by saying that if by reason of the investment of his profits in an extension of his yards he has constructed a plant which was necessary in time of war to meet the demands which were made upon him at that time for production, but which after the termination of the war has depreciated in value because not needed; in that case, under the amortization provision he will be allowed to amortize to the full extent of the depreciation value. Of course, if there is salvage he would be allowed to amortize only down to the salvage value." (Congressional Record, February 17, 1919, p. 3774.) Under the rule established by the regulation last quoted "reproduction cost" as of April, 1919, which in most cases would exceed the cost of property to be amortized was taken as a temporary basis, final determination being postponed until "stable postwar conditions" arrived. In order, therefore, to have secured present relief by virtue of the amortization provision of the statute by extinguishing amortization by the difference between "salvage value" and original cost, the taxpayer must have permanently discarded property before December 15, 1919 (or the last installment date). The injustice of taking "salvage value" in one case and "reproduction cost" in another may be illustrated by the case of the taxpayer who had purchased two machines and discarded one of them, and another taxpayer who had purchased one machine of a capacity equivalent to the capacity of the two machines of the first taxpayer. Under the last quoted rule, the former would immediately obtain the benefit of the amortization provision and the latter would not have obtained it until the problematical time when "stable postwar conditions" return, if ever. This came close to being arbitrary discrimination.

In any case where a taxpayer has deducted on account of amortization an amount in excess of the preliminary estimate of 25% of the cost of property and it is found upon consideration that he is entitled to an amount exceeding 25% of the cost of the property, but less than the amount originally deducted, the 5% penalty and 1% interest on account of negligence has been held due on account of amortization claimed but disallowed in the return for 1918. In the event that the case is reopened within a period of three years and an additional amount of amortization allowed, the penalty and interest will not attach to the amount of tax based on the additional allowance granted. In other words, penalty and interest should attach only to such amount of tax as, upon final settlement, is found to have been due to the government and not paid at the time of filing return by reason of the taxpayer's disregard of the regulations.[110]

Amortization Period. The amortization allowance will be spread in proportion to the net income (computed without benefit of the amortization allowance) between January 1, 1918 (or if the property was acquired subsequent to that date, January 1st of the year in which acquired), and either of the following dates:

(*a*) If the claim is based on (1) of the preceding paragraph, the date when the property was or will be sold or permanently discarded as a war facility; or (*b*) if the claim is based on (2) of the preceding paragraph, the actual or estimated date of cessation of operation as a war facility.

All taxpayers claiming an allowance for amortization should compute (or, to the extent that accurate computations can not be made, should estimate) the amount of their net income for the period between January 1, 1918, and the dates specified above, and should also compute (or estimate as above) that part thereof properly assignable to each of the calendar years falling within the amortization period; and the amount of income so computed or estimated will be the basis for apportioning the amounts of amortization applicable to each of the calendar years affected.

110 A. R. M. 24, T. B. 3-20-692. This 25% limitation upon the amount which might be deducted in 1919 returns is hardly supported by a statute prescribing a "reasonable" deduction, unless in the particular case 25% is a reasonable deduction. The above ruling recognizes the tentative quality of the 25% limitation, and makes that limitation simply a penalty upon honest as well as fraudulent calculations of the deduction in 1919 returns. In effect it was an attempt to induce conservative calculations. It hardly seems fair, if technically permissible, to assess a penalty upon honest over-estimates, made at a time when the difficulty of making any estimate hardly needs statement. For cases that a regulation in conflict with the statute is invalid, see Chapter 47.

Taxpayers reporting on the fiscal year basis should (*a*) in all computations based upon 1918 rates for fiscal years ending in 1918 and 1919, use the amount of such allowance apportioned to the calendar year 1918; (*b*) in all computations based upon 1919 rates for a year beginning in 1918 and ending in 1919, use the amount of such allowance apportioned to the calendar year 1919; and (*c*) in all computations for subsequent fiscal years, use the number of twelfths of the allowance apportioned to each calendar year falling within such fiscal year that there are months of such calendar year falling within such fiscal year.[111] A claim for amortization applicable to the portion of the calendar year 1918 covered by the return of the taxpayer for the taxable year 1918 should be included in such return and if such amortization is not claimed therein it may not be taken in the return covering the taxable year 1919. The return for the taxable year 1919 should provide only for the proper amortization applicable to such taxable year ascertained in accordance with the above provisions. However, in cases where it was impracticable to determine accurately the amortization during the calendar year 1919, any returns made during such period should include amortization allowances tentatively determined in accordance with this and the preceding paragraphs. Returns made for the taxable year 1918, in cases where the taxpayers are entitled to amortization claims should include such claims ascertained as above provided, and if subsequently the amortization as finally determined differs essentially from the amount claimed in the returns filed, then amended returns should be made.[112]

REDETERMINATION OF AMORTIZATION ALLOWANCE. Redetermination of the deduction allowed on account of amortization may, or at the request of the taxpayer must, be made by the Commissioner at any time within three years after the termination of the recent war (March 3, 1924), and if as a result of an appraisal or from other evidence it is found that the deduction originally allowed was incorrect, the amount of tax due for each taxable year during the amortization period will be adjusted by additional assessment or by refund.[113]

SALE OF AMORTIZED PROPERTY. In the case of the *bona fide* sale of amortized property before three years from the termination of the war, the sale price thereof will be considered as reflecting the correctness or incorrectness of the amortization al-

[111] Reg. 45, Art. 185, as amended by T. D. 3123, T. B. 6-21-1439.

[112] Letter from treasury department dated June 9, 1919; I. T. S. 1919, ¶ 3391.

[113] Reg. 45, Art. 187.

lowance made, due allowance being made for depreciation sustained since the close of the amortization period.[114]

INFORMATION TO BE FURNISHED BY TAXPAYER. The taxpayer's claim for amortization must be complete and comprehensive in all respects. The Commissioner will not entertain claims which do not clearly set forth full data with respect to the property which it is desired to amortize. To assist the taxpayer in compiling this information the Commissioner has prepared Guide Form 1007-M, which explains in detail the manner in which claims for amortization should be presented. A copy of this guide form will be furnished to the taxpayer upon application to the Commissioner.[115]

[114] Reg. 45, Art. 188, as amended by T. D. 3123, T. B. 6-21-1439.
[115] Reg. 45, Art. 189; T. D. 3123, T. B. 6-21-1439.

CHAPTER 27

DEPLETION—IN GENERAL

The Revenue Act of 1921 contains a provision for the deduction of an allowance for depletion in the case of mines, oil wells, gas wells or any other natural deposits and timber.[1] The same allowance is permitted to individuals as to corporations and is permitted to nonresident aliens or foreign corporations with respect to property located in the United States. Depletion is the loss sustained through the progressive removal or exhaustion of natural resources, such as a mineral deposit or timber supply.[2] Depletion allowances are made because mineral deposits and timber supplies are exhaustible and because each unit removed reduces the amount recoverable, and hence the value of the property. The depletion provisions of the 1918 Law was identical with that of the present law, except that it did not contain the limitation prescribed by the Revenue Act of 1921 in regard to depletion based on discovery values.[3] The 1916 Law provided for an allowance for depletion in the case of mines, oil and gas wells.[4]

That law provided, in the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production, and in the case of mines a reasonable allowance not to exceed the market value in the mine of the product thereof which had been mined and sold during the year for which the return and computation were made. The present law does not limit the deduction for depletion in the same way, but permits a reasonable allowance according to the peculiar conditions of each case. The 1916 Law, the 1918 Law and the present law permit the allowance for depletion to be based upon the value of the property as of March 1, 1913, or the cost, if the property has been acquired since that date. The 1916 Law made no reference to

[1] Revenue Act of 1921, § 214 (a) 1, 234 (a) 9.

[2] This is forcibly stated in the latest Manual of the Oil and Gas Industry (p. 17) as follows: "These reserves are wasting assets from the moment production begins, for the reason that there is no recuperation or rehabilitation of any part or portion that has been removed from the rock containing them. They are gone forever so far as human needs are concerned. The only way to meet the increased requirements of industry is to exhaust separate reserves rapidly and discover new sources of supply."

[3] See Revenue Act of 1918, §§ 214 (a) 10 and 234 (a) 9.

[4] Revenue Act of 1916, §§ 5, 6 and 12.

lessees and the treasury department ruled thereunder that a lessee could claim no depletion with respect to the value of the natural deposit on March 1, 1913.[5] The present law provides that in the case of leases the deduction shall be equitably apportioned between the lessor and the lessee. With respect to depletion the treasury department has ruled as stated in the following paragraphs.[6] These rulings, while made under the 1918 Law, will be equally applicable under the present law.

Depletion of Mines, Oil and Gas Wells; Depreciation of Improvements.[7] The Revenue Act of 1921[8] provides that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. The provisions of the statute and the rules stated in this and the following paragraphs do not apply to or affect the regulations covering invested capital, losses, and accounting methods. The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold,[9] shall within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (*a*) his capital invested in the property, or (*b*) the value of his property on the basic date, plus subsequent allowable capital additions, but not including land values for purposes other than the extraction of minerals. Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a stockholder in a mining or oil or gas corporation is not allowed such deductions.

Definition of Terms. When used in this and the following chapters:

(*a*) The term "basic date" indicates the date of valuation, i. e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery, or within 30 days thereafter, in the case of discovery.

[5] See paragraph "Rule as to Lessees under Prior Laws," p. 728.

[6] This chapter gives only the general rules with respect to depletion. The special rules with respect to mines, oil and gas wells, and timber are given in the chapters following.

[7] Reg. 45, Art. 201.

[8] §§ 214 (a) 10 and 234 (a) 9.

[9] Under the 1916 Law no allowance for depletion was permitted in the case of a lessee, but the lessee was permitted to claim "depreciation" on the actual bonus or other cost incurred in acquiring and developing property. (See p. 728.)

(*b*) The "fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase. Where there has been no sale and the fair market value at the basic date is to be used, such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date.[10]

(*c*) A "mineral property" or "property" is the oil or gas well, including the mineral, plant, development, and surface value of the land. The value of a mineral property is the combined value of its component parts.

(*d*) A "mineral deposit" refers to "minerals only," such as the "ores only" in the case of a mine, to the "oil only" in the case of an oil well, and to the "gas only" in the case of a gas well. The value of a mineral deposit is its cost; or it is the value of the mineral property, less the value of the plant, equipment, and surface of the land for purposes other than mineral production.

(*e*) "Minerals" comprise ores of the metals, coal, oil, gas, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand and gravel, silicia, slate, soapstone, soda, sulphur, and talc.

(*f*) "Operating profit" is the net income from mineral production before depletion and depreciation are deducted. It is distinct from net income.[11]

Capital Recoverable Through Depletion Deduction in Case of an Operating Owner.[12] In the case of an operating owner in fee, the capital remaining in any year recoverable through depletion and depreciation[13] deductions is (a) the cost or value of the property at the basic date plus (b) subsequent allowable capital additions and minus (c) depletion and depreciation sustained.

[10] The meaning of the term "fair market value" is discussed in Chapter 17, as well as the character of evidence which is acceptable in proof hereof.

[11] Reg. 45, Art. 201.

[12] Reg. 45, Art. 202.

[13] Depreciation should be claimed on all physical property. The "physical property" as to which depreciation, as distinguished from depletion, should be claimed in the case of the oil and gas industry is enumerated elsewhere in this book. (See p. 764.) Depletion applies only to the loss due to exhaustion of the natural resource.

whether legally allowable or not,[14] from the basic date to the taxable year, and minus (d) the value of the land at the basic date for other purposes than mineral production.[15] The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

Capital Recoverable Through Depletion Allowance in Case of Lessee.[16] (a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

(b) The value of the equities of lessor and lessee must be computed separately, but, when determined as of the same basic date, may together never exceed the value at that date of the property in fee simple.

(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is the value of his interest in the mineral as of that date.

(d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost.

(e) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within 30 days thereafter, of his equity in the mineral discovered.

Where a taxpayer made claim under the placer mining laws to public land, which was withdrawn by executive order prior to completion of valid location (and prior to March 1, 1913), and later (subsequent to March 1, 1913), operated the land under agreement with the secretary of the interior, or lease from the government, he is not entitled to a depletion deduction based upon the value of his claim as of March 1, 1913, but, under the provi-

[14] It is to be noted that the ruling contemplates that depletion must be taken consistently from year to year and more depletion than is allocated to the production of one year cannot be taken by reason of the fact that less has been deducted in a past year than could have been properly allocated to such past year. The depletion which has or should have been taken must be based upon the same cost or fair market value and is subtracted whether or not it (or any part thereof) has been allowed under earlier laws. T. B. R. 4, T. B. 1-19-53.

[15] That is, in the case of an owner the value of the surface of the land should not be considered as a part of the value of the natural deposit.

[16] Reg. 45, Art. 203. See T. D. 3089, T. B. 47-20-1313.

sions of the Revenue Acts of 1918 and 1921, he is entitled to a depletion deduction based upon the discovery value as to discoveries made subsequent to the acquisition of the lease or leases from the government.[17]

BONUSES. Bonuses constitute a part of the cost of the leasehold. Any annual or periodical rents or flat royalties (as in the case of gas wells) supplementing the bonuses or other amount paid for the lease at the time of acquisition may be charged to cost of leasehold until the property reaches the operating stage and will form part of the capital returnable through deductions for depletion.[18] Under an option to purchase, or so-called "bond and lease" agreement, providing for the payment of royalties on ore mined and for the payment at stated times of the amounts necessary to bring the total amounts paid to certain specific sums, and giving an option to the purchaser to take title to the property upon the payment of a specified amount upon which the royalties and deficiency payments are credited as part of the purchase price, it has been held that the additional sums paid to make up the amounts of the several installments when due are capital investments in the nature of bonuses and are recoverable through deductions for depletion computed upon the total sum of such additional payments to the end of the taxable year. Where the option is forfeited, the capital sum remaining to be recovered is deductible as depletion in the year in which the forfeiture occurs.[19]

Capital Recoverable Through Depletion in Case of Lessor.[20] (*a*) In the case of a lessor, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

(*b*) The value of the equities of lessor and lessee must be com puted separately, but, when determined as of the same basic date, may together never exceed the value at that date of the property in fee simple.

17 Sol. Op. 118, T. B. 36-21-1801.

18 Manual for the Oil and Gas Industry, p. 20.

19 Sol. Op. 86, T. B. 4-21-1406.

20 Reg. 45, Art. 204. See T. D. 3089, T. B. 47-20-1313.

(*c*) The value of the lessor's equity in the case of a mineral property not under lease on March 1, 1913, but subsequently leased, is the en bloc value of the mineral in the ground on March 1, 1913, and will, in the absence of satisfactory evidence to the contrary, be presumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.

(*d*) The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits is the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date.

(*e*) The value of a lessor's equity in a mineral property under lease for a portion of its operating life is the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease plus the estimated en bloc value of the mineral remaining at its expiration, which, in the absence of satisfactory evidence to the contrary, will be presumed not to exceed the value as of March 1, 1913, of royalties which could have been expected as at that date from the remaining mineral.

(*f*) The value of a lessor's equity in a mineral property when acquired on or after March 1, 1913, is its cost.

(*g*) The value of a lessor's equity in a discovery on or after March 1, 1913, is the fair market value at the date of discovery, or within 30 days thereafter, of his equity in the mineral discovered.

Determination of Cost of Deposits. In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral rights, or leasehold was acquired, the owner or lessee will be required to show that the cost or price at which the property was bought was fixed for the purpose of a *bona fide* purchase and sale, by which the property passed to an owner, in fact as well as in form, other than the vendor.[21] No fictitious or inflated cost

[21] That is, owners of a natural deposit will not be allowed to base depletion on a greater value by reason of incorporating or re-incorporating where the change of ownership is one of form and not substance. The treasury department has uniformly insisted, however, upon the imposition of an income tax upon transferrors of property to a corporation, even if the beneficial ownership remains the same (See Chapter 17). This practice has been rendered impossible under the present law, but under the 1918 and prior laws it would seem clear that the transfer of property by an individual to a corporation, or by one corporation to another, in exchange for stock, will establish a new cost measured by the market value of the stock at the date of the transaction. In other words,

or price will be permitted to form the basis of any calculation of a depletion or depreciation deduction, and in determining whether or not the price or cost at which any purchase or sale was made represented the actual market value of the property sold, due weight will be given to the relationship or connection existing between the person selling the property and the buyer thereof:[22]

Determination of Fair Market Value of Mineral Property. A determination of the fair market value of a property (or the taxpayer's interest therein) is required:

(*a*) In connection with the computation of depletion allowances: (1) *As of March 1, 1913,* in the case of properties acquired prior to that date; (2) *At the date of discovery or within 30 days thereafter* in the case of mines, oil and gas wells, discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is disproportionate to the cost; (3) *As of the date of conveyance or acquisition,* if subsequent to March 1, 1913, in the case of property paid for with stock of a corporation, the value of the stock representing "cost" of the properties, and such stock value being frequently only possible of calculation by reference to the value of the assets it represents; (b) In connection with invested capital: (1) In computing the amount which may be included in paid-in surplus, *as of date of conveyance or acquisition,* where tangible property has been conveyed to a corporation by gift or at a value accurately established or definitely known as at date of conveyance clearly and substantially in excess of the cost or of the par value of the stock or shares paid therefor; (2) In computing the amount which must be deducted from capital and surplus *as of the date of conveyance or acquisition* in order to limit invested capital to the actual cash value of tangible property, other than cash, *bona fide* paid in for stock or shares; (c) In connection with the computation of profit and loss from sale of capital assets in the case of properties: (See Chapter 17); (1) *As of March 1, 1913,* in the case of properties acquired prior to that date; and (2) *As of the date of acquisition,* in order to ascertain "cost" in the case mentioned in (a) (3) above. (3) *As of the date of the transaction,* where the prop-

such new corporation becomes an "owner in fact as well as in form, other than the vendor". Congress expressly provided that such transfers should not affect invested capital (Revenue Act of 1918, § 331; Revenue Act of 1917, § 208) but these provisions obviously have no reference to the "capital sum" for purposes of depletion or depreciation.

[22] Reg. 45, Art. 205.

erty is sold for stock of a closely held corporation having no other property, in order to ascertain "Selling price" (not under 1921 Law).

The treasury department has ruled as follows: (a) Where the fair market value of property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or in methods of extraction and treatment of the mineral product.[23] The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purposes of capital stock tax, valuation for local or state taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods, such as the present value method and other factors.

(*b*) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors are (1) the total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed, (2) the average quality or grade of the mineral reserves, (3) the expected percentage of extraction or recovery in each process or operation necessary for the preparation of the crude mineral for market, (4) the probable operating life of the deposit in years, (5) the unit operating cost, i. e., cost of production exclusive of depreciation and depletion, (6) expected average selling price per unit during the operating life, and (7) the rate of profit commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recov-

[23] See Sol. Op. 80, T. B. 5-21-1418.

ery, costs of production, and selling price of the product marketed during the expected operating life of the mineral deposit.

(*c*) Mineral deposits for which these factors may not be determined with reasonable accuracy from past operating experience may, with the approval of the Commissioner, be valued in a similar manner; but the factors must be deduced from concurrent evidence such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits in the property itself, the intensity of mineralization, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the property, and other evidence tending to establish a reasonable estimate of the required factors.

(*d*) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property must be valued separately. The mineral content of the deposit should be determined in accordance with the rules stated in the following chapters. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or definitely adopted at the basic date for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating cost comprises all current expense of producing, preparing, and marketing the mineral product sold, exclusive of federal income, war-profits, and excess-profits taxes, allowable capital additions,[24] and deductions for depreciation and depletion, but including cost of repairs and replacements necessary to maintain the plant and equipment at its rated capacity and efficiency. This cost of repairs and replacements is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

[24] See Reg. 45, Art. 222.

(e) The product of the number of units of mineral recoverable in marketable form by the difference between the selling price and the operating cost per unit is the total expected operating profit. The value of each mineral deposit is then the total expected operating profit from that deposit reduced to a present value as of the basic date at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at the basic date of appreciable assets and of the capital additions, if any, necessary to realize the profits.[25]

Revaluations of Mineral Deposits Not Allowed.[26] No revaluation of a property whose value as of the basic date has been determined and approved will be allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of discovery.[27] The value as of the basic date may, however, be corrected when a virtual change of ownership of part of the property results as the outcome of litigation, and may be redistributed (a) when a revision of the number of units of mineral in the property has been made in accordance with the rules set forth elsewhere[28] in this book, and (b) in case of the sale of a part of the property, between the part sold and part retained.

Computation of Deduction for Depletion of Mineral Deposits. (*a*) Depletion attaches to the annual production "according to the peculiar conditions of each case" and when the depletion actually sustained, whether legally allowable or not, from the basic date, equals the cost or value on the basic date plus subsequent allowable capital additions, no further deduction for depletion will be allowed except in consequence of added value arising through discovery or purchase.

(*b*) When the value of the property at the basic date has been determined, depletion for the taxable year is determined by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion, so determined, by the number of units sold within the taxable year. In the selection of a unit for depletion preference must be given to the principal or customary unit or units paid for in the product sold.[29]

Limitation Upon Depletion Based on Discovery Value. Under the 1921 Law a new provision is inserted, placing a limitation on

[25] Reg. 45, Art. 206.

[26] Reg. 45, Art. 207.

[27] For a definition of discovery, see pages 758 and 760.

[28] See pages 000 and 000.

[29] Reg. 45, Art. 210.

the depletion deduction when based upon discovery value. It is now provided that the depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913.[30] The purpose of this provision has been stated to be "in order to make it certain that the depletion deduction when based upon discovery value shall not be permitted to offset cr cancel profits derived by the taxpayer from a separate and distinct line of business."[31]

Adjustments of Accounts Based on Bonus or Advanced Royalty. (*a*) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum is to be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

(*b*) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor may be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

[30] Revenue Act of 1921, §§ 214 (a) 10 and 234 (a) 9. This is the one respect in which the depletion provision of the present law differs from the corresponding provision of the 1918 Law.

[31] See Report of Senate Finance Committee on the Revenue Bill of 1921, p. 15.

(*c*) If, for any reason, any such mineral lease is terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor must adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account must be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(*d*) Upon the expiration, termination, or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor will be required to restore to capital account so much of the bonus received and deducted from capital recoverable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned.[32]

Depletion and Depreciation Account on Books. Every taxpayer claiming and making a deduction for depletion and depreciation of mineral property must keep accurate ledger accounts in which shall be charged fair market value as of March 1, 1913, or within 30 days after the date of discovery, or the cost, as the case may be, (a) of the mineral deposit, and (b) of the plant and equipment together with subsequent allowable capital additions to each account. These accounts should thereafter be credited annually with the amounts, whether legally allowable or not, of the depreciation and depletion sustained, or the amount of the depreciation and depletion sustained should be credited to depletion and depreciation reserve accounts to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus subsequent allowable capital additions, no further deduction for depletion and depreciation with respect to the property will be allowed.[33]

[32] Reg. 45, Art. 215.

[33] Reg. 45, Art. 216. Because of the fact that depreciation and depletion deductions are applied against different capital sums, which are usually returnable at different rates, it is essential that these accounts be kept separately; that is, the cost or value of physical property subject to depreciation with deductions for depreciation enter into one account; the cost or value of the property (exclusive of physical property), together with additions for such development costs as have not been charged to current operating expenses, enter into a separate account against which depletion may be charged.

Rule Under the 1909 Law. The Act of August 5, 1909, did not provide for deductions from gross income on account of depletion of natural resources. The fact that revenues derived from operating mines resulted to some extent in exhaustion of the capital established under that law no ground for the deduction from gross income of the value of the ore extracted.[34] Lessors could claim no deduction from royalties with respect to depletion.[35] Lessees were allowed to claim a deduction of a proportionate amount of the cost of the lease, but not of the value of the deposit at the incidence of the tax.[36] Although the treasury department prescribed rulings for determining depletion under the 1909 Law[37] such rulings were not authorized by the statute, and a corporation which had claimed depletion thereunder could not claim that the treasury department was estopped by such regulations from assessing the tax without the benefit of any depletion under that law.[38]

Rule Under the 1913 Law. The 1913 Law allowed the taxpayer to deduct from the gross income of the taxable year on account of depletion of natural deposits an amount not to exceed 5% of the gross value of the output of the ore at the mine during the year.[39] The term "gross value at the mine" was held to mean in the case of a coal mine the market value of the prepared coal at the mine where such value is established by actual sales at the mine; and, where the market value is established at some place other than the mine, the price for which the coal is sold less transportation charges.[40] The law did not require that the charge for depletion of natural deposits must actually be set up on the books of the taxpayer in order to constitute an allowable deduction. It was first held that such an entry must be made in order to obtain the benefit of the allowance,[41] but it was later held that failure to write off depletion would not result in a disallowance of the deduction.[42] It is now held that: "An operating owner will determine the amount which he is entitled to deduct in his return as depletion by adding to the amount paid for the deposit or to its fair market value as of

34 Stratton's Independence v. Howbert, 231 U. S. 399.
35 Von Baumbach v. Sargeant Land Co., 242 U. S. 503.
36 Biwabik Mining Co. v. U. S., 247 U. S. 116.
37 T. D. 1675.
38 Goldfield Consolidated Mines Co. v. Scott, 247 U. S. 126.
39 Act of October 3, 1913, ¶ B and ¶ G.
40 S. 1365, T. B. 18-20-900.
41 Letter from treasury department dated May 18, 1916.
42 T. D. 2481.

March 1, 1913, if acquired prior thereto, such costs of development since that date, as have not been deducted as expenses on his returns, and by dividing the resultant sum by the number of units in the mine estimated as of the time of its acquisition or as of March 1, 1913, if acquired prior thereto, thereby determining the per unit cost or value. The taxpayer is then entitled to deduct as depletion for the years 1913, 1914 and 1915 the product of the per unit cost or value multiplied by the number of units produced within the year, provided such amount does not exceed 5 per cent. of the gross value of the output for the year at the mine."[43] Under the 1913 Law and under the 1916 Law a lessor is permitted a depletion allowance which is computed like that of an operating owner, except that where a mine was leased before March 1, 1913, the allowance for depletion in favor of the lessor is based not on the fair market value of the ore or mineral in place as of March 1, 1913, but on the lessor's interest therein on that date.[44]

Rule as to Mine Under the 1916 Law. Under the 1916 Law an operating owner is entitled to a reasonable allowance for depletion, limited in the case of mines to the market value in the mine of the product thereof mined and sold during the year, not exceeding in the aggregate the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date. In a case arising under the 1916 Law the price at which property was offered for sale on May 1, 1914, has been accepted as the fair market value of mining property on March 1, 1913, in the absence of evidence showing a change in value between these two dates.[45] In order that a taxpayer may have the benefit of the authorized deduction for depletion, the amount claimed must actually be charged off on his books before the allowance can be granted.[46] An operating owner will deter-

[43] Extract from circular entitled "Schedule for Depletion—1909-1917," issued by the treasury department, Mines and Minerals Section, 1919.

[44] Id. But since the courts have held that a lessee acquires no interest in the mineral deposits in place, but only the privilege of entering upon the premises and mining and removing such deposits, it would seem that the lessor's interest in a deposit as of March 1, 1913, was not, for the purpose of claiming depletion under the 1913 and 1916 Laws, diminished by reason of a lease existing on that date.

[45] S. 1365, T. B. 18-20-900.

[46] The amount need not however be written off in the taxable year. It is sufficient if the amount is charged off before being allowed as a deduction. Consequently at the time of an examination of a corporation it is allowed to reopen its books and charge off depletion actually sustained for any taxable year during which the 1916 Law was in effect. If, however, the

mine the amount which he is entitled to deduct as depletion by adding to the amount paid for the ore or mineral or to its fair market value as of March 1, 1913, if acquired prior thereto, such costs of development since that date as have not been deducted as expenses, and by dividing the resultant sum by the number of units in the mine estimated as of the time of its acquisition or as of March 1, 1913, if acquired prior thereto, thereby determining the per unit cost or value. The taxpayer is then entitled to deduct as depletion for the year 1916 and subsequent years the product of the per unit cost or value multiplied by the number of units produced within the year. However, when the aggregate of such deductions shall equal the cost or fair market value as of March 1, 1913, plus the amount subsequently expended in developing the property which had not been deducted as an expense, the taxpayer will be entitled to no further deductions.[47]

In a case arising under the 1916 Law, a taxpayer leased mineral property in 1910 for a royalty of 20 cents a ton for a period of 10 years. In 1913 it was determined that the property was very valuable and had a large tonnage of ore which would extend its life, at the probable rate of extraction, until 1940. In 1920 he renewed the lease for the life of the mine for a royalty of $1.00 per ton. It was ruled that the value of the taxpayer's interest as of March 1, 1913, in the ore in the mine was the present worth, as of that date, of his royalties of 20 cents per ton, obtained by multiplying the royalty per ton by the number of tons probable extraction by the lessee and discounting the product for the remaining life of the lease, plus the value of the ore which would be left in the mine at the termination of the lease. The fair market value of the ore in the mine as of March 1, 1913, having been determined, "a reasonable allowance" for depletion under such lease was the then present worth of his royalties, provided this did not exceed such fair market value. Upon the renewal of the lease in 1920 for the remaining life of the mine, the taxpayer's interest in the capital sum would again be represented by the royalties stipulated to be paid, capitalized

facts do not warrant the opening of the books and charging off depletion for any past year, it will not be allowed as a deduction. Thus, for example, if all the earnings of a year have been distributed and there is nothing from which to credit a reserve for depletion no allowance for depletion can be credited to a reserve account or permitted as a deduction. (Letter from treasury department dated June 25, 1918; I. T. S. 1919, ¶ 2119.)

[47] Extract from circular entitled "Schedule for Depletion 1909-1917," issued by the treasury department, Mines and Minerals Section, 1919.

and discounted as above, and its present worth divided by the estimated mineral content of the mine at the date of the lease would equal the unit of depletion which, multiplied by the number of tons extracted in any year, would give the allowable deduction for depletion for such year, provided always that such deduction does not exceed the value as of March 1, 1913, of the ore extracted during such year.[48]

Rule as to Lessees Under Prior Laws. As mining leases are held not to convey the mineral deposits in place, but only the privilege of entering upon the premises and mining and removing such deposits, under none of the Acts of 1909, 1913, or 1916 is a lessee entitled to deduction from income on account of depletion. But under the provisions of the Acts of 1909, 1913, and 1916, authorizing the deduction from gross income of the ordinary and necessary expenses of the business, including rentals, the lessee may deduct royalties paid as such necessary expenses, and in the event that he paid a lump sum for his lease, such sum may be considered as rent paid in advance and, together with the cost of development not deducted as expenses, may be divided by the estimated number of units in the mine as of the date of acquisition in order to determine the expense per unit for the purpose of deduction. The lessee is then entitled to deduct as expense the product of the per unit expense multiplied by the number of units produced within the year. If the lessee is unable to determine the proper amount based upon investment in accordance with the method outlined above, he may deduct in his return the pro rata portion of the amount expended for the lease and for development based upon the life of the lease.[49]

In a case[50] arising under the 1916 Law it appeared that the Mohawk Mining Company on February 7, 1905, acquired a mining lease upon a tract of land in Minnesota, paying $81,250 therefor and agreeing to pay a royalty of $0.25 per ton as the ore was mined and removed from the premises. Immediately thereafter the mining company entered into possession of the leased property and opened a mine, spending a large sum of money in sinking

[48] Sol. Op. 80, T. B. 5-21-1418.

[49] Extract from circular entitled "Schedule for Depletion—1909-1917" issued by the Treasury Department, Mines and Minerals Section, 1919.

[50] Mohawk Mining Co. v. Weiss, U. S. Dist. Ct., No. D. of Ohio, I. T. S. 1919, par. 3635. The case was submitted to the Circuit Court of Appeals on February 9, 1920, and this court reversed the lower court on March 2, 1920. The opinion was corrected and refiled on June 15, 1920. The Court rendered a further opinion on June 15, 1920, on a petition for a rehearing. (See 254 Fed. 502.)

shafts, driving entries, etc. On March 1, 1913, there were 1,106,-389 tons of ore in the mine, of an agreed value of $0.49875 per ton, considering the entire deposit *en bloc*. The value of the lease on March 1, 1913, was $275,214.26. The term was sufficient to enable the lessee to mine out all the ore. In its 1916 and 1917 returns the mining company deducted allowances for depletion—$46,096.61 in 1916 and $66,467 in 1917, such depletion being at the rate of $0.24875 per ton on the ore removed in such years. Of these amounts the Commissioner allowed a deduction in 1916 and 1917 at the rate of $0.04 per ton on the ore removed in such years, it being agreed that such amount, when applied to all the ore known to be in the mine in 1905, would free from tax the $81,250 originally paid for the lease by the mining company. The disallowance of any further depletion was based solely on the ground that the mining company was not the owner of the ore or mine content, but was only the lessee or contractor.[51] In reversing the decision of the district court permitting an allowance for depletion and reversing the Commissioner, the circuit court of appeals relied almost entirely upon a decision of the United States Supreme Court under the 1909

[51] The Court said: "We cannot conceive any substantial distinction as applied to a mine between that depreciation *or allowance for capital assets consumed* which was sought by mine owners under the earlier acts, and that depletion which was expressly allowed by the amendment of 1916. From every point of view, this kind of depreciation *or allowance* was depletion and this allowed depletion is depreciation *or diminution of capital* and when the question or right to the allowance arises as between fee owner and lessee, it can make no difference whether the claimed allowance is called by one name or by the other. In U. S. v. Biwabik Co., 247 U. S. 116 (arising under the Act of 1909), it was ruled, after full consideration, that under a lease practically identical with the Mohawk lease now involved, the nature of the interest held by the lessee was not such as to permit it to claim the allowance, but that the contingencies which attended the character of the lessee's interest barred it from claiming that its capital assets had been diminished. It is true that the question whether the mining of ore could be considered depreciation in any event was underlying, and that this question has been completely removed by the amendment of 1916, but the Supreme Court did not rest its conclusion at all upon the definition of depreciation." (Original opinion as revised.) "In the Biwabik case, the lessee was not heard to say that his capital assets had been consumed by his mining operations, and we interpret that decision as resting in an essential degree on the idea that the nature of the lessee's title forbade him to make this claim. We can not read the decisions of the supreme court as having determined that the exhaustion of ore reserves is so inherently a business loss rather than an impairment of capital, that a statutory grant of the right to deduct for depletion on that account will reach a case which has been adjudged not to involve the diminution of capital assets. We think the substantial prin-

law.[52] In this case the defendant acquired a leasehold in certain ore producing properties in Minnesota from which it mined ore from that date to and including the year 1910. This lease was acquired by payment to the prior lessee of the sum of $612,000 in addition to contracting to pay a royalty of $0.30 per ton upon ore mined. In its 1910 return the defendant deducted the sum of $265,372.08 "to cover realization of unearned increment." The amount of this deduction was arrived at by multiplying the number of tons of ore mined during the year by $0.4875, which was the market value of the ore in place on January 1, 1909. The district court held that the deduction could not be allowed since the lease was not a conveyance of the ore in place, but was merely a grant of the privilege of entering upon the premises and mining and removing the ore. This court allowed, however, the deduction of the sum of $0.03885 per ton, which represented an allowance of part of the cost of $612,000 calculated upon a per unit basis. This decision of the district court was reversed by the circuit court of appeals.[53] The Supreme Court, however, repudiating the construction of its earlier opinions placed upon such opinions by the circuit court of appeals, held that the defendant was not entitled to the depletion claimed. The Supreme Court did not pass upon the propriety of the deduction of $.03885 per ton allowed by the district court as the government had taken no writ of error as to this partial deduction. This decision of the United States Supreme Court must be considered in the light of the prior decisions of the Supreme Court upon the question of depletion under the 1909 law[54] and also in the light of other contemporary decisions holding that in determining net income under the 1909 Law arising from the conversion of

ciples established by the decisions are that both the royalty received by the fee owner and the sums received by the operating lessee above the cost of operation are income; that the statutory reduction for 'depletion' cannot be twice credited, once to the fee owner and one to the lessee; and that the exemption belongs of right to the fee owner." (On petition for rehearing.) In the case under consideration this gives the fee owner a depletion allowance of $.49875 per ton although his royalty under the contract is only $.25 per ton. The contention of the lessee, however, was not that each should claim an allowance of $.49875 per ton but that such aggregate value per ton on the deposit *en bloc* should be shared by lessor and lessee.

52 U. S. v. Biwabik Mining Co., 247 U. S. 116.

53 Biwabik Mining Co. v. U. S., 242 Fed. 9.

54 Stratton's Independence v. Howbert, 231 U. S. 399; Von Baumbach v. Sargent Land Co., 242 U. S. 503. The decision in Goldfield Consolidated Mines v. Scott, 247 U. S. 126, was made on the same day as the Biwabik decision and reiterates the force and effect of the other cases cited, adding nothing material to the discussion of the principles involved.

the capital assets of a taxpayer acquired before January 1, 1909, there might be deducted from the gross proceeds of the conversion an amount sufficient to restore the capital value existing on December 31, 1908.[55] The essential substance of the first of the decisions on depletion[56] was that (1) the proceeds of ores mined by a corporation from its own premises constitute income under the 1909 Law, and (2) a corporation is not entitled under that law to deduct the value of such ore in place before it is mined, from such income. The former of these two conclusions was based upon the consideration that the 1909 Law was not an *income* tax law, but imposed an excise tax on corporations engaged in business measured by net income as defined in the act. The mining company, being within the taxing clause and not within the exempting clause, was taxable upon net income as defined in the act. Thus, it seems, the income used as a measure of the 1909 tax, according to the Supreme Court, need not necessarily be true net income and may include amounts which, properly speaking, are return of capital, in a business that theoretically or practically involves a wasting capital, especially when such income is easy of ascertainment and simply applied in practice.

In the next case[57] involving depletion the Supreme Court held that (1) so-called royalties received by the owners of lands leased for mining purposes were income within the meaning of the 1909 Law and (2) the resulting exhaustion of ore body was not an element to be considered in determining the reasonable depreciation allowed as a deduction by the 1909 Law. The former of these decisions was based upon an analysis of the mining leases involved and a citation of numerous Minnesota cases to the effect that such leases did not constitute a sale of any part of the land or ore in place. The second decision was based upon a strict interpretation of the word "depreciation," which was held not sufficiently broad to include "depletion."

Clearly, at the time the Biwabik case was decided, an owner was not entitled to any allowance for depletion under the 1909 Law, whether the mine was operated by him or he was a lessor. All the Biwabik case decided was that a lessee could not have an allowance to which a lessor was not entitled. The decision put the lessor and the lessee on an equality, and was a necessary

55 Doyle v. Mitchell Bros., 247 U. S. 179; Hays v. Gauley Mountain Coal Co., 247 U. S. 189; Lynch v. Turrish, 247 U. S. 221; U. S. v. Cleveland, etc., Ry. Co., 247 U. S. 195.

56 Stratton's Independence v. Howbert, 231 U. S. 399.

57 Von Baumbach v. Sargent Land Co., 242 U. S. 503.

corollary of the two prior decisions of the court. The real reason why an allowance for depletion was denied to the lessee mining company in the Biwabik case was that the statute contained no provision permitting such depletion to any one, under the head of depreciation or otherwise.

It seems that in the Mohawk mining case the circuit court of appeals misconstrued the Biwabik case. The circuit court of appeals' understanding of the essence of the Biwabik decision is indicated by its statement that "the nature of the interest held by the lessee was not such as to permit it to claim the allowance" and that the "nature of the lessee's title forbade him to make this claim." This is not true. If the lessee had had the title of the lessor, he would have been entitled to no depletion. No one was entitled to depletion. The nature of a mining property, not "the nature of the lessee's title," prohibited the deduction, under the 1909 Law.

This misapprehension is probably based upon the language of the Supreme Court, reading as follows: "The lessee takes from the property the ore mined, paying for the privilege so much per ton for each ton removed. He has this right or privilege under the form of lease here involved so long as he sees fit to hold the same without exercising the privilege of cancellation herein contained. He is, as we held in the Sargent Land Co. case, in no legal sense the purchaser of the ore in place." But this language appears not to have been the basis of the decision but a mere restatement of the rule that the kind of lease involved did not constitute *pro tanto* a purchase. The statement immediately follows the criticism of the circuit court of appeals' statement to this effect.

It was perhaps necessary to reiterate this point since on the same day[58] of the Biwabik decision the Supreme Court also decided other cases which held that upon the conversion of capital assets a taxpayer was entitled to deduct from the proceeds received the value of assets at the date of the incidence of the tax.[59] If the kind of lease involved had been such as to effect a sale or conversion of capital assets or ore in place, the lessor (but not the lessee) would have been entitled to what would have amounted to a depletion deduction. But this would not necessarily have helped the lessee since, even if the lease had effected a conversion of capital assets or sale of ore in place, the lessee would merely have assumed the position of an owner

[58] May 20, 1918.

[59] Doyle v. Mitchell Bros., 247 U. S. 179; U. S. v. Cleveland, etc., Ry. Co., 247 U. S. 195; Hays v. Gauley Mountain Coal Co. 247 U. S. 189.

who had already been denied depletion. The lease would not have effected a *sale by him;* it would have meant a *purchase by him.*

The Revenue Act of 1913 and that of 1916, allow depletion.[60] Under both statutes the department has held that depletion is allowed only to the owner. But the lessee is allowed a deduction to provide for the amortization of his capital investment in the property, and such deduction may be measured annually in the same manner as depletion is measured—by production, or may be measured by the life of the lease. No deduction has been allowed for the value of a lease on March 1, 1913, in excess of the capital investment on that date. A very serious question arises in this connection, which the Mohawk case does not settle, namely, if the lessee had a lease on March 1, 1913, possessed of a fair market value, how is he to separate that value from his receipts in order not to be taxed on what was capital at the incidence of the tax, and on which he can not be taxed in the case of a sale under the decisions of the Supreme Court.[61]

In the case of mines the lessee has been held in the cases heard by the Supreme Court not to be the purchaser of any ore in place. Not being the purchaser, the lessee is not owner and the statute seems to limit depletion to property owned by the taxpayer. Under the theory that leases do not effect a sale of ore in place, the property of the lessee is not the ore but the contract permitting its extraction. It is intangible, not tangible property, and any allowance to the lessee must be based upon the theory that such intangible property or contract right is exhausted by its use or employment in the lessee's business or trade.

[60] The 1913 Law permitted the deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made." (Act of October 3, 1913, G (b).) The Revenue Act of 1916 provided for the deduction in the case of individuals "(a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, * * *" (Revenue Act of 1916, Sections 5, 6 and 12).

[61] See Doyle v. Mitchell, 247 U. S. 179; Lynch v. Turrish, 247 U. S. 221; note distinction, however, in Lynch v. Hornby, 247 U. S. 339.

[62] See Reg. 33, Rev. Art. 171.

It is possible that mineral deeds or leases of land situated in states other than Minnesota may be held to constitute a sale of minerals in place, in which case a different conclusion as to the rights of lessor and lessee under the 1909 Law might follow and also a different conclusion under the 1913 and 1916 Laws as to lessees.

The regulations issued under the 1916 Law provided that "the deduction in the case of a lessee (of a mine) will be limited to an amount equal to the *capital actually invested in the lease,* without regard to value as of March 1, 1913, or any other date."[62] Under this regulation it has been held that where a corporation organized for the purpose takes over a mining lease, issuing its entire capital stock to the individual owners of the lease in proportion to their respective interests therein, the "capital actually invested in the lease" is represented by the fair market value of the stock so issued.[63]

Depletion for Past Years Not Allowed Under Present Law. Where under the act of October 3, 1913, or of September 8, 1916, a taxpayer has not been allowed to make a deduction for the full amount of his depletion, the amount of such deficiency can not be carried forward and deducted in any later year. Depletion attaches to each unit of mineral or other property removed, and a taxpayer should make proper provision therefor in computing his net income. Under the Revenue Acts of 1918 and 1921 the amount recoverable through depletion will be the cost, or the value as of March 1, 1913, or within 30 days of the date of discovery, as the case may be, less proper allowance for the mineral or other property removed prior to January 1, 1918.[64]

[63] O. 1033, T. B. 20-20-938.

[64] Manual for the Oil and Gas Industry, p. 45.

CHAPTER 28

DEPLETION OF MINES

The provision of the law permitting the deduction of an allowance for depletion in the case of mines, oil wells, gas wells, or any other natural deposits and timber, has been set forth and discussed generally in the preceding chapter. It is shown in that chapter that this allowance is based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or (c) upon the fair market value within thirty days after the date of discovery in the case of mines discovered by the taxpayer after February 28, 1913, where the fair market value is seriously disproportionate to the cost. As shown in the preceding chapter, the Revenue Act of 1921 limits the depletion deduction when based on discovery value and provides that such deduction shall not exceed the net income, computed without allowance for depletion, from the property on which discovery is made. Subject to any changes occasioned by this limitation the regulations issued under the 1918 Law remain applicable. The depletion allowance is permitted to operating owners, lessors and lessees, and the capital recoverable through the depletion allowance in the case of each and the rules with respect to the apportionment of the deduction between lessor and lessee are discussed in the same chapter.[1] In general, the allowance for depletion is ascertained by multiplying the number of mineral units extracted from a mine each year by the unit value. The unit value is ascertained by dividing cost, or value as of March 1, 1913, or within 30 days after discovery, by the number of mineral units in the property as of the date of acquisition or valuation.[2] The preceding chapter should be consulted for the rulings regarding depletion generally; certain special rules relating specifically to mines are set forth below.[3]

Determination of Mineral Contents of Mine. Every taxpayer claiming a deduction for depletion for a given year will be required to estimate or determine with respect to each separate

1 Reg. 45, Art. 201.

2 Reg. 45, Art. 210.

3 Many of the rules stated in the next chapter with regard to the oil and gas industry have a general application and should be consulted for additional information.

property the total units (tons, pounds, ounces, or other measure) of mineral products reasonably known or on good evidence believed to have existed in the ground on the basic date, according to the method current in the industry and in the light of the most accurate and reliable information obtainable. Preference must be given in the selection of a unit of estimate to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the property for the purposes of valuation and depletion should include as to both quantity and grade (a) the ores and minerals "in sight," "blocked out," "developed," or "assured," in the usual or conventional meaning of these terms in respect to the type of the deposit, and (b) "probable" or "prospective" ores and minerals (in the corresponding sense), that is, ores and minerals that are believed to exist on the basis of good evidence, although not actually known to occur on the basis of existing development; but "probable" or "prospective" ores and minerals may be computed, for purposes of this valuation, (c) as to quantity, only in case they are extensions of known deposits or new bodies or masses whose existence is indicated by geological or other evidence to a high degree of probability, and (d) as to grade, of such richness only as accords with the best indications available.[4] Where a taxpayer discovered that a coal vein on his property was lacking to the extent of certain acreage by reason of the discovery in 1917 of a rock fault, it has been held that he is not entitled to loss under the heading of "loss of useful value," but be may revise his estimate of recoverable ore and the capital remaining may be recovered by depletion deductions in subsequent years. If the mining operation of this property was discontinued entirely in the taxable year, the deduction for depletion should be taken in that year so that the return of capital may be complete.[5]

Statement to be Attached to Return Where Depletion or Depreciation of Mineral Property is Claimed. To the return of every taxpayer claiming a deduction for depletion or depreciation there should be attached a statement setting forth with respect to each mineral property (1) whether the taxpayer is a fee owner, lessor, or lessee; (2) the date of acquisition, and if under lease its exact terms and date of expiration; (3) the cost of the property stating the amount paid to each vendor with his name and address; (4) the basic date at which the property is

[4] Reg. 45, Art. 208.

[5] A. R. R. 431, T. B. 12-21-1521.

valued; (5) the value of the property on the basic date with a statement of the precise method by which it was determined; (6) the value of the surface of the land for purposes other than mineral production; (7) the estimated number of units of mineral at the basic date, with an explanation of the method used in the estimation, and an average analysis which will indicate the quality of the mineral valued; (8) the number of units sold during the year for which the return is made; (9) the gross and net income derived from the sale of mineral; (10) the amounts deducted for depletion; (11) the amounts sustained on account of depletion or on account of depreciation stated separately from the basic date to the taxable year; and (12) any other data which will be helpful in determining the reasonableness of the deductions claimed in the return. To the return of every taxpayer claiming a deduction for depletion in respect of (1) property in which he owns a fractional interest only or (2) a leasehold, or (3) property subject to lease there should also be attached a statement setting forth the name and address and the precise nature of the holding of each person interested in the property, and every lessor is required to attach to his return an affidavit stating, as of the date of filing the return, whether the lease involved is still in effect during the year covered by the return, and if not still in effect when it was terminated and for what reason and whether the lessor has repossessed the property.[6]

Discovery of Mines. To entitle a taxpayer to a valuation of his property for the purpose of depletion allowances, by reason of the discovery of a mine on or after March 1, 1913, the discovery must be made by the taxpayer after that date and must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the newly discovered mine contains mineral in such quantity and of such quality as to afford a reasonable expectation of return to the taxpayer of an amount materially in excess of the capital expended in making such discovery plus the cost of future development, equipment, and exploration.

A mine may be said to be discovered when (1) there is found a natural deposit of mineral, or (2) there is disclosed by drilling or exploration, conducted above or below ground, a mineral deposit not previously known to exist and so improbable that it had not been, and could not have been, included in any previous valuation for the purpose of depletion, and which in either case

[6] Reg. 45, Art. 217.

exists in quantity and grade sufficient to justify commercial exploitation. The discovery must add a new mine to those previously known to exist and can not be made within a proven tract or lease as defined below.

In determining whether a discovery entitling the taxpayer to a valuation has been made, the commissioner will take into account the peculiar conditions of each case; but no discovery, for the purposes of valuation, will be allowed as to ores, or minerals, such as extension of known ore bodies, that have been or should have been included in "probable" or "prospective" ore or mineral, or in any other way comprehended in a prior valuation, nor as of date subsequent to that when, in fact, discovery was evident, when delay by the taxpayer in making claim therefor has resulted or will result in excessive allowances for depletion.

The value of the property claimed as a result of a discovery must be the fair market value, as defined in the preceding chapter, based on what is evident within thirty days after the commercially valuable character and extent of the discovered deposits of ore or mineral have with reasonable certainty been established, determined, or proved. After a *bona fide* discovery the taxpayer must adjust his capital and depletion accounts in accordance with the rules stated in the preceding chapter and must submit such evidence as to establish his right to a revaluation, covering the conditions and circumstances of the discovery and the size, character, and location of the discovered deposit of mineral, the value of the property at the prior basic date, the cost of discovery, and its development, equipment and exploitation, its value and the particular method used in the determination.

In the case of a mine, a "proven tract or lease" includes, but is not necessarily limited to, the mineral deposits known to exist in any known mine at the date as of which such mine was valued for purposes of depletion, and all extensions thereof, including "probable" and "prospective" ores considered as a factor in the determination of their value or cost.[7]

A taxpayer is not entitled to a new valuation for depletion in a known mine; a discovery can not be made of any "probable"

[7] Reg. 45, Art. 219. The term "discovery" has been defined in a number of cases relating to the location of mining claims, but the word "discovery" as used in this statute is not used in the sense employed in Revised Statutes § 2320, under which section it has been held that a sufficient "discovery" to justify a location on public lands need not be a discovery that the ground contains mineral in sufficient quantities to pay. See Words and Phrases, Volume 3, p. 2094.

or "prospective" ores which had been or could have been included in the previous valuation, and the regulations do not recognize a discovery for the purpose of depletion as the result of improved processes of treatment of ores making commercially valuable ores which were theretofore valueless. If bodies of zinc ore not theretofore known to exist were discovered within the meaning of the regulations, the fact that the explorations were stimulated by recent improvements in metallurgy which made them commercially valuable for the first time would not bar a claim for discovery, and if the original valuations of the taxpayer were based upon estimates of recoverable units, which included only the ores in sight and blocked out, the properties may be revalued as of the basic date and the depletion rate determined accordingly.[8]

Allowable Capital Additions in Case of Mines. All expenditures for development, rent, and royalty in excess of receipts from minerals sold should be charged to capital account recoverable through depletion, while the mine is in the development stage. Thereafter any development which adds value to the mineral deposit beyond the current year should be carried as a deferred charge and apportioned and deducted as operating expense in the years to which it is applicable.

All expenditures for plant and equipment should be charged to capital account recoverable through depreciation, while the mine is in the development state. Thereafter the cost of major items of plant and equipment should be capitalized but the cost of minor items of equipment and plant, necessary to maintain the normal output, and the cost of replacement may be charged to current expense of operation.[9] All expenditures by a mining company for prospecting and development for the purpose of enlarging the business or continuing it beyond its present limits must be charged to capital account.[10]

Accumulated Depletion. A lessor of mining property who waived his right to royalties for several years on account of the fact that the mine was operated at a loss, and received all of the royalties in the year 1917, may, if he has submitted returns for those years on a cash receipts and payments basis, deduct from the income received in 1917 such depletion allowance as appertains to that income.[11]

[8] A. R. M. 124, T. B. 19-21-1620.
[9] Reg. 45, Art. 222.
[10] O. D. 314, T. B. 26-19-589.
[11] A. R. M. 17, T. B. 2-20-674.

CHAPTER 29

DEPLETION OF OIL AND GAS WELLS

The provisions of the Revenue Act of 1921 permitting the deduction of an allowance for depletion in the case of mines, oil wells, gas wells, or other natural deposits and timber, has been set forth and discussed generally in another chapter.[1] This allowance is based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or (c) upon the fair market value within 30 days after the date of discovery in the case of mines discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost. The depletion provision of the Revenue Act of 1918 was identical with that of the present law except that the present law contains the following limitation: "Such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913."[2] The essence of the depletion provision is that the owner of mineral deposits, whether leasehold or freehold, shall secure through an aggregate of annual depletion and depreciation deductions the amount indicated in (a), (b), or (c), whichever applies to his particular case, plus in any case the subsequent cost of plant and equipment (less salvage value) and underground and overground development, which is not chargeable to current operating expense, but not including land values for purposes other than the extraction of minerals.[3]

"Capital Sum." The term "capital sum" is used in this chapter to denote the total amount recoverable to the taxpayer by means of depletion, depreciation, and obsolescence allowances. Both "cost of property" and "cost of development," in so far as they have not been decreased by allowable deductions, are chargeable to capital sum and are returnable through the several allowable deduc-

[1] Revenue Act of 1918, §§ 214 (a) 10, 234 (a) 9.

[2] Revenue Act of 1921, § 214 (a) (10) and § 234 (a) (9).

[3] Reg. 45, Art. 201. It has seemed necessary for the clearer understanding of this chapter to repeat some of the rules stated in Chapter 27; where possible, however, this has been avoided. Reference is made to that chapter for definitions of various terms used herein.

tions. Structures and equipment may also be included in capital assets and are returnable through depreciation. In the case of revaluations as of March 1, 1913, or within 30 days of a discovery by the taxpayer made subsequent to February 28, 1913, the value thus established plus consequent costs not otherwise deducted becomes the total of "capital sum." This revaluation, however, does not affect the invested capital. Development costs (except the cost of physical property) may be deducted as an expense in the year in which they are paid out or at the option of the taxpayer may be charged to capital sum. Election once made under this option is final and will control the returns for all subsequent years.[4]

Cost of Property. Cost of property includes all amounts (in cash or its equivalent) paid for and incident to the establishment of title and acquisition of the lease or fee, as the case may be, such as—purchase price of lease or fee; purchase price of physical property; salaries or commissions paid to brokers or agents; fees to geologists, attorneys, surveyors, etc., for examination and defense of title, establishing boundaries, etc., state and county fees for recording and legalizing transfers, and all other payments made in acquiring and establishing title to the properties.[5]

Cost of Development. Cost of development comprises all payments made for and incident to the drilling of wells, such as for (1) physical property; (2) geological and other surveys, made subsequent to acquisition; (3) roads; (4) water supplies; (5) hauling; (6) wages; (7) drilling; (8) shooting; (9) overhead charges (incident to drilling of wells); (10) fuel; and (11) all other similar expenditures.[6]

"Capital Sum" and "Invested Capital." The term *Capital Sum* is applied to the total amount returnable to the taxpayer through depletion, depreciation, and obsolescence allowances. It is to be clearly distinguished from the term "invested capital," which is the basis for the determination of war-profits credits and excess-profits credits of corporations. It has no necessary relation to the "invested capital." It may represent the investment of funds belonging to the taxpayer, or the investment of borrowed funds, which have no relation to invested capital; under the provisions of the law and regulations, the capital sum may include amounts based upon the right of valuation as of March 1, 1913, or within 30 days after the discovery of oil or gas by the taxpayer. Where such valuations are allowable, they have no application to in-

[4] Manual for the Oil and Gas Industry, p. 10.
[5] Manual for the Oil and Gas Industry, p. 9.
[6] Manual for the Oil and Gas Industry, p. 10.

vested capital,[7] and may not be used for any purpose other than as a basis for depletion, depreciation, and obsolescence, or as a basis upon which to determine the gain or loss arising from the sale or surrender of property acquired prior to March 1, 1913. With respect to any allowance for amortization the basis is the cost of property acquired after April 5, 1917, and no amount may be added on account of revaluation for discovery. Neither may any revaluation on account of discovery be used in determining gains or losses on the sale of mineral properties.[8]

Capital Recoverable Through Depletion Deduction in Case of an Operating Owner. In the case of an operating owner in fee, the capital remaining in any year recoverable through depletion and depreciation deductions is (a) the cost or value of the property at the basic date plus (b) subsequent allowable capital additions and minus (c) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (d) the value of the land at the basic date for other purposes than mineral production. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation. Where depletion deductions for former years have or should have been taken these amounts are to be subtracted from the capital sum returnable through depletion deductions. In no case may the amount returnable through deductions for depletion include items against which depreciation is being charged; that is, the cost (or value) of physical property may not be included, since it is returnable through depreciation deductions.[9]

Capital Recoverable Through Depletion Deduction in the Case of Lessee. (a) In the case of a lessee, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

(b) The value of the equities of lessor and lessee must be computed separately, but, when determined as of the same basic date, may together never exceed the value at that date of the property in fee simple.

[7] Except as indicated in Reg. 45, Art. 844 (2).

[8] Manual for the Oil and Gas Industry, p. 29. See Chapter 2.

[9] Reg. 45, Art. 202; Manual for the Oil and Gas Industry, p. 20.

(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is the value of his interest in the mineral as of that date.

(d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost.

(e) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within 30 days thereafter, of his equity in the mineral discovered.[10]

Capital Recoverable Through Depletion Deduction in the Case of Lessor. (a) In the case of a lessor, the capital remaining in any year recoverable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production. The capital recoverable through depletion is the total capital remaining less the sum recoverable through depreciation.

(b) The value of the equities of lessor and lessee must be computed separately, but, when determined as of the same basic date, may together never exceed the value at that date of the property in fee simple.

(c) The value of the lessor's equity in the case of a mineral property not under lease on March 1, 1913, but subsequently leased, is the en bloc value of the mineral in the ground on March 1, 1913, and will in the absence of satisfactory evidence to the contrary, be presumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.

(d) The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits is the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date.

(e) The value of a lessor's equity in a mineral property under lease for a portion of its operating life is the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease plus the estimated en bloc value of the mineral remaining at its expiration, which, in the absence of satisfactory evidence to the contrary, will be presumed not to exceed the value as of March 1, 1913, of royalties

[10] Reg. 45, Art. 203; A. R. R. 570, T. B. 37-21-1818.

which could have been expected as at that date from the remaining mineral.

(f) The value of a lessor's equity in a mineral property when acquired on or after March 1, 1913, is its cost.

(g) The value of a lessor's equity in a discovery on or after March 1, 1913, is the fair market value at the date of discovery, or within 30 days thereafter, of his equity in the mineral discovered.[11]

Determination of Cost of Deposits. The cost of oil and gas properties is determined in accordance with the rules set forth in another chapter.[12]

Fair Market Value of Oil or Gas Properties. The determination of the fair market value of an oil or gas property (or the taxpayer's interest therein) and the rules and tests and evidence bearing on the determination of market value are set forth in another chapter.[13] No revaluation of property will be permitted, as stated more fully in the same chapter.

Determination of Quantity of Oil in Ground. In the case of either an owner or lessee it will be required that an estimate, subject to the approval of the Commissioner, shall be made of the probable recoverable oil contained in the territory with respect to which the investment is made as of the time of purchase, or as of March 1, 1913, if acquired prior to that date, or within 30 days after the date of discovery, as the case may be. The oil reserves must be estimated for all undeveloped proven land as well as producing land. If information subsequently obtained clearly shows the estimate to have been materially erroneous, it may be revised with the approval of the Commissioner.[14] The estimate of probable recoverable oil in the ground is fundamentally necessary if a reasonable deduction for depletion is to be calculated, and, while it may be impossible to determine exactly the future production of a well or tract, it has been found possible to predict future productions with a comparatively narrow limit of error. The result of analysis of a great volume of production records has led to the development of the method suggested in the following paragraph.[15]

Method of Estimating Recoverable Reserves. The taxpayer may estimate his recoverable reserves by any methods

11 Reg. 45, Art. 204.

12 See page 718.

13 See Chapter 27. See also Chapter 17.

14 Reg. 45, Art. 209.

15 Manual for the Oil and Gas Industry, p. 29.

that can be shown to be well founded, but in all cases the data upon which such estimate was based must be submitted, with a description of the method employed and a resume of the calculations. The treasury department does not prescribe any particular method of estimating recoverable reserves, but various methods, applicable to a wide variety of conditions have been suggested by the treasury department.[16]

These methods may be summarized as follows:

1. Plotting the record of production of individual wells, or, lacking such detailed information, the average production per well for each tract.

2. Deriving from these graphical records an average or composite production decline curve for the district.

3. Estimating from the last year's average production per well the probable future production, based on the average production decline curve, or a future production curve derived from the production decline curve.

4. Ascertaining probable total future production of producing wells by multiplying average future production per well by the number of wells producing at the end of the year.

5. Estimating the probable future production of undeveloped proven land on the basis of nearby production, making due allowance for the decline in pressure due to the extraction of oil from the pool.

Computation of Allowance for Depletion of Oil Wells. The method of computing the depletion allowance has been given in a previous chapter as applicable to all natural resources.[17] In general, the allowance for depletion of oil wells is ascertained by multiplying the number of mineral units extracted from a well each year by the unit value. The unit value is ascertained by dividing cost, or value at the basic date remaining for depletion, by the number of barrels of oil or units of gas to which this diminished cost or value is applicable.[18] Each barrel of oil or unit extracted and marketed must, before a profit can be realized, pay not only its proportionate share of the operating expense and deductions for depreciation and obsolescence of physical property, but also must pay its proportionate share of capital sum returnable through depletion allowances. This proportionate share of capital sum returnable through depletion allowances, which each unit of oil or gas must pay, is *unit cost*. Unit cost is obtained by

16 See Manual for the Oil and Gas Industry.

17 See page 722.

18 Reg. 45, Art. 210. For a full statement of this rule, see Chapter 27.

dividing the capital sum returnable through depletion by the "*estimated recoverable* reserve" at the beginning of the taxable year. The recoverable reserves used in deriving the unit cost should be the taxpayer's share only. The depletion deduction is computed by multiplying the unit cost by the number of units produced during the taxable year.[19]

[19] The following illustration shows the effect of the rule stated in the text:

A, a lessee, has an oil lease in which his original investment (exclusive of value of physical property) was	$20,000
Development cost (exclusive of cost of physical property) not otherwise deducted	80,000
Capital returnable through depletion allowance	$100,000
Estimated gross recoverable reserves at end of taxable year barrels	400,000
Gross production during taxable year .... barrels	100,000
Gross reserves oil at beginning of year .... do	500,000
Lessee's share ($\frac{7}{8}$) .... do	437,500
Lessor's share ($\frac{1}{8}$) .... do	62,500
Total .... do	500,000
Therefore unit cost for lessee is $\frac{\$100,000}{437,500}$, or, per barrel	$0.2285
Lessee's share of production during year is $\frac{7}{8}$ of 100,000, or, barrels	87,500
A's depletion allowance for the taxable year is, therefore, 87,500 x $0.2285	$19,993.75
B, the owner in fee of the property, had invested	$40,000
Of which the value of the land exclusive of oil rights represents	25,000
The investment in the oil deposit is	$15,000
B's unit cost is, therefore, $\frac{\$15,000}{62,500}$, or, per barrel	$0.24
Lessor's share of production is $\frac{1}{8}$ of 100,000 barrels, or	12,500
And his depletion allowance for the same year is 12,500 x $0.24, or	$3,000

The above example presupposes that B leased his land without bonus.

Any amount received by a lessor as bonus for an oil and gas lease on the property would reduce his capital sum by that amount.

Illustration:

The lessor's (B's) investment in the deposit is	$15,000
He receives as bonus	5,000
His net investment in the deposit is, therefore	$10,000
He sells a one-half interest in his royalty for	$6,000
As this half cost him	5,000
His profit is	$1,000

REVISED ESTIMATE OF RESERVES. If proper additions are made to the capital account represented by the original cost or value of the property, or circumstances make advisable a revised estimate of the number of mineral units in the ground, a new unit value for purposes of depletion may be found by dividing the capital account at the end of the year, less deductions for depletion to the beginning of the taxable year which have or should have been taken, by the number of units in the ground at the beginning of the taxable year. This number, unless a revision of the original estimate has been made, will equal the number of units in the ground at the date of original acquisition or valuation less the number extracted prior to the taxable year. If, however, a recalculation is made, the number of units at the beginning of the year will be the sum of the gross production of the year and the estimated mineral reserves in the property at the end of the year. If a certain proportionate part of the lessee's capital returnable through depletion deductions is deducted in a given year the same *proportion* of the lessor's capital sum returnable through depletion will be deducted.[20]

Computation of Allowance for Depletion of Gas Wells. On account of the peculiar conditions surrounding the production of natural gas it will be necessary to compute the depletion allowance for gas properties by methods suitable to the particular cases in question and acceptable to the Commissioner. Usually the depletion of natural gas properties should be computed on the basis of decline in closed or rock pressure, taking into account the effects of water encroachment and any other modifying factors. The gas producer will be expected to compute the depletion as accurately as possible and submit with his return a description of the method by which the computation was made. The following formula, in which the units of gas are pounds per square inch of closed pressure, is recommended: The quotient of the capital account recoverable through depletion allowances to the end of the taxable year divided by the sum of the pressures at the beginning of the year plus the sum of initial pressures of

And is subject to tax as income.

His capital sum remaining is	$5,000
If he had sold a one-half interest in his royalty for	4,000
He would have sustained a loss of	$1,000

and should deduct this amount from gross income as a loss in computing his tax.

20 Manual for the Oil and Gas Industry, p. 30.

new wells and less the sum of the pressures at the time of expected abandonment (which quotient is the unit cost) multiplied by the sum of the pressures at the beginning of the taxable year plus the sum of the initial pressures of new wells and less the sum of the pressures at the end of the tax year equals the depletion allowance.[21] The above methods are more fully discussed in the following paragraphs.

Details of Production or the Performance Record of the Well or Property. As a general rule the demand on a natural gas property is a variable factor. In certain fields, however, the demand from some wells has from the beginning, or for considerable periods, been greater than the supply, so that the amount of gas marketed per well may, as in the case of oil, show a regular decline, which will be indicative of the total amount that the well may be expected to produce, and also the rate of production. Even where the demand does not greatly exceed the supply, the amount and rate of past production may in certain cases throw light on the future of the well or property.[22]

Decline in Open-Flow Capacity. Where data are available the decline in open-flow capacity indicates in a general way the rate of exhaustion of the gas field. The relationship is not at all close and varies from field to field and from well to well. Also for most gas wells accurate data on decline in open-flow capacity are not available. Nevertheless it is probable that for certain properties this method will have value, for with rare exceptions the production of gas from a well leads to a decline in its capacity, and the fraction produced is roughly proportional to the decline.[23]

Comparison with Life History of Similar Wells or Properties Particularly Those Now Exhausted or Nearing Exhaustion. Where no other data are available the rate of depletion of a gas well or property may be approximated by comparison with a neighboring well or property that has reached a later stage in life. Particularly is this applicable in a district where many gas wells have become exhausted. For example, in a region where wells produce during a period of 8 to 12 years, or an average of 10 years, a 10 per cent. deduction will be a rough approximation of the rate of depletion.[24]

Size of Reservoir and Pressure of Gas, or the Pore-Space Method. For some properties the pore-space method may be

21 Reg. 45, Art. 211; Manual for the Oil and Gas Industry, p. 32.

22 Manual for the Oil and Gas Industry, p. 32.

23 Manual for the Oil and Gas Industry, p. 32.

24 Manual for the Oil and Gas Industry, p. 32.

best for estimating underground supplies of natural gas and for a good many it will furnish additional evidence of value. The method would be ideal if the average percentage of pore-space, the extent and thickness of the sand, and the pressure of the gas could be accurately ascertained. In computing the reserves of an individual property by this method the migratory character of gas must be considered and the production and behavior of adjacent properties taken into account. The factors that make the method difficult to apply are difficulty of accurately ascertaining the thickness of pay, limits of pool, percentage of pore-space, the effect of encroaching water and oil, and the quantity of gas remaining when commercial production is no longer possible. Take, for example, a pool where there is no encroachment by water. Suppose that the pore-space is 25 per cent., the thickness of the pay 20 feet, and the extent of the pool 10 square miles, or roughly 280,000,000 square feet. The volume of the reservoir would be 1,400,000,000 cubic feet, and the amount of gas in the sand could be readily computed by taking into account the closed pressure of the wells.[25]

Other Indications of Depletion. Additional evidence of decreasing supply of natural gas in the ground is commonly observable in the behavior of the wells and the provision that must be made for transporting the gas to market. Observations on minute pressures show more or less progressive change as the wells become older and an increasing amount of gas is drawn from the ground. Line pressures and pressures at compressing stations are also likely to show a progressive change in the same direction. The appearance of water or oil in a gas well or in neighboring gas wells may be a very significant symptom of the approaching termination of the life of the well. The clogging of gas wells by paraffin, salt, or other deposits may demand modification of depletion estimates.[26]

Closed-Pressure Method. Because of its general applicability, the closed-pressure method is by far the best method of estimating the depletion of gas properties. Unfortunately, accurate closed-pressure data have not been kept for all properties or perhaps even for the majority of properties, but the rock pressure in most pools is known or is ascertainable with a fair degree of accuracy, and the information drawn from the pressure decline is, with the exception of a few fields, not subject to profound modification because of factors whose value can not be appraised.

[25] Manual for the Oil and Gas Industry, p. 33.

[26] Manual for the Oil and Gas Industry, p. 33.

The basis of this method is Boyle's law. According to this law of physics, if gas is pumped into a vessel until the pressure is 200 pounds and then is drawn off until the pressure is 100 pounds, the size of the vessel remaining fixed, and ignoring for the moment atmospheric pressure, it may be concluded that one-half of the gas has been drawn out of the vessel. If an underground gas reservoir of fixed dimensions is tapped by wells and the pressure is found to be a thousand pounds, and then if the gas is drawn off through the wells until the gas pressure in the pool is lowered to 100 pounds, we may infer that about nine-tenths of the supply of gas has been exhausted.[27]

"UNIT COST" AS APPLIED TO NATURAL GAS. Although, as a rule, the number of cubic feet of gas under a tract can not be satisfactorily estimated and the quantity that will be marketed is even less definite, the "unit cost method" can be used by regarding pounds of closed pressure as units, for the actual quantity of gas underground commonly varies with the decline in pressure and the relative quantity at the beginning and end of the tax year and at the time of abandonment, is, in the lack of better information, usable for tax purposes.[28]

CORRECTIONS AND REFINEMENTS OF CLOSED-PRESSURE METHOD. Several corrections and more or less important refinements are made in applying this method to the computation of depletion, and it should be borne in mind that it does not afford data on the *amount* of gas originally in the pool or at any later specified time, but only the *fraction* of the gas that has been removed from its natural reservoir and the fraction remaining in that reservoir. Perhaps the most important of these corrections arises out of the fact that the size of the reservoir does not remain fixed but becomes smaller as the gas is drawn and water or oil advances into a part of the space formerly occupied by the gas. The pressure is thus prevented from declining at a rate proportionate to the amount of gas drawn from the pool. The correction on account of water or oil encroachment is difficult to make, because of the lack of data to determine the extent of the encroachment. However, in a good many pools, after a study of the distribution of wells that have been "drowned out" and the history of water troubles in similar near-by pools, it is possible to make allowance for water or oil encroachment which will more or less closely approximate the facts.

[27] Manual for the Oil and Gas Industry, p. 33.

[28] Manual for the Oil and Gas Industry, p. 34.

Another refinement applicable to the computation of depletion of natural gas by the closed-pressure method is based upon the fact that even where there is no encroachment of water or oil the depletion is not precisely represented by the gauge readings, though the errors are generally so small that they may be ignored. For example, where the pressure declines from 1,000 to 500 pounds, the gas is not exactly half gone, for the reason that the pressures referred to are gauge readings and to each should be added the pressure of the atmosphere—for most fields about 14.4 pounds to the square inch. The fraction remaining in the ground then becomes $\frac{514.4}{1014.4}$.

Account should also be taken of the pressure at which wells are abandoned in the field or district.

If wells can not be operated with profit after the pressure has declined to 25 pounds gauge reading (39.4 pounds absolute), then the percentage of recoverable gas remaining when the pressure has declined from 1,000 to 500 pounds gauge reading is not one-half of even the fraction $\frac{514.4}{1014.4}$ but $\frac{475}{975}$. The difference in the fraction where pressures of several hundred pounds are involved is not great and scarcely worth considering in view of the other errors which are certain to affect the result. However, after the pressure has declined to a low figure, the matter of correcting the fraction becomes of considerable importance. Thus, if the pressure of abandonment is 4 pounds gauge reading and during the year the average closed pressure of a pool has declined from 10 pounds to 5 pounds gauge reading, five-sixths instead of one-half of the recoverable gas has been withdrawn.

Still another refinement that has, as a rule, more theoretical than practical value may be worthy of consideration in certain instances. This arises out of the fact that the gases do not expand precisely as the pressure decreases, and that even if the size of the natural reservoir remains fixed the pressure does not decline in exact proportion to the amount of gas removed. The difference amounts to only a few per cent. and is greatest for high pressures. In the decline from 1,000 to 500 pounds per square inch the gas expands several per cent. more than would be calculated by a strict application of Boyle's law, and in a decline from 1,500 pounds to 1,000 pounds the departure is still greater. The correction varies from field to field because of the different constitution of the gases, though since most natural gases consist largely of methane the variations on account of differences in gases are not great.

A fourth detail of refinement arises out of the fact that o. the average more gas is marketed for 50 pounds of decline in pressure after the pressure has reached 100 pounds or less than an equal decline while the pressure is high, as, for example, 1,000 pounds per square inch. Also the expense of marketing gas after the pressure has become low is greater than when it was high, largely because of the necessity of installing compressors to push the gas through the pipe lines to the consumers. These two considerations have a tendency to balance each other and, with certain exceptions, will not be of sufficient importance to warrant an attempt to apply the corrections.[29]

METHOD OF GAUGING. In using the closed-pressure method of estimating depletion, the method of gauging is of vital importance and in many fields is not carried out with sufficient care. Care should be taken to make sure that the gauge is accurate, testing it before and after attaching it to the well. If it must be transported far or is subject to much jolting in transportation, a gauge tester should be taken along and used at the well. Care should also be taken to empty the well of oil and water by pumping, blowing, or siphoning before attaching the gauge, for any liquid in the hole will lower the closed pressure reading. The well should be closed long enough to allow the pressure to build up to its maximum. The length of time necessary for this purpose varies a great deal from field to field and well to well. The well should remain closed until the pressure will not build up more than 1 per cent. in 10 minutes. Ordinarily, 24 hours will be sufficient for this purpose, but for some wells several days or even a longer period will be required, owing to the slowness of equalization of pressure in the sand.[30]

APPORTIONMENT OF DEPLETION AMONG VARIOUS SANDS. Where more than one sand under a property is yielding gas, the problem arises as to how to weigh or evaluate the decline in pressure in the different sands. Suppose there is a very good gas sand in which the pressure declines from 600 to 300 pounds during the year, and a very poor sand in which the pressure declines from 800 to 750. The depletion sustained is not indicated by the average decline in pressure but is more nearly proportionate to the decline in the good sand. If accurate figures on capacities of wells are obtainable, it will be possible to make a fairly accurate weighting of the pressure declines, or if facts indirectly indicating capacity of individual wells are obtainable some light may be

[29] Manual for the Oil and Gas Industry, p. 34.

[30] Manual for the Oil and Gas Industry, p. 35.

thrown on the question. But, as a general rule, it is necessary to average the decline of wells drawing from different sands as though they were drawing from the same sand.[31]

SEASON FOR TESTING WELLS FOR CLOSED PRESSURE. For many fields summer or early fall readings furnish the best indication of decline in closed pressure. It is therefore recommended that such readings be taken regularly and consistently. Summer or fall readings are of especial value because these seasons for most fields are at the end of a period during which the wells have not been subject to heavy draft, and hence are in best condition to accurately reflect the pressure of the gas in the underground pool or reservoir. If pressures of all wells or representative wells are observed regularly and carefully in summer or early fall, these readings may in many cases be applied direct to the end of the taxable year, though in some cases it may be possible and desirable to estimate the pressures at the end of the taxable year from pressures observed at other times. Obviously, it will not be possible to test the pressures of all wells at the exact end of the taxable year.

If in one part of a tract a gas well is brought in at a pressure of 1,000 pounds and during the remainder of the taxable year the pressure declines to 700 pounds, the rough inference may be drawn that three-tenths of the gas has been taken from the tract and, subject to corrections in certain cases, three-tenths of the capital returnable through depletion may be charged off. Suppose that some time in the next taxable year a gas well is completed on another part of the tract and that its initial pressure is 800 pounds. If by the end of the year the pressure of this well has declined to 700 pounds while the pressure of the first well has dropped to 500 pounds, the fraction of the capital account returnable through depletion the second year is proportional to the average decline in pressure, assuming that there are no water troubles or other noteworthy complications. The average of 700 and 800 is 750 and the average of 500 and 700 is 600. The difference or average decline in pounds or units of gas is 150, and this represents a decline of 20 per cent. from 750. It will be noted that the exact date of completion of the new well does not enter the computation and it is treated as though it were finished at the beginning of the year. The rate of decline within the year is of little consequence, the main consideration being the amount of decline for the whole year. If the year's decline occurred within a month, or even a week, it is treated the same as though it were

31 Manual for the Oil and Gas Industry, p. 36.

spread over the entire year. Abandoned wells may be regarded as fully depleted and their pressure counted as zero in computing depletion. Consider the wells just described and assume that in the third year a third well is brought in and one of the old wells is abandoned. Suppose the pressure at the first well declined from 500 pounds to about zero and the well is abandoned, the second well to 300 pounds and the third to 600. The pressure of the two old wells at the beginning of the year and of the new one at its completion averaged 600 pounds, and the average of the three at the end of the year was 300. The depletion indicated is 50 per cent. of the remaining capital account. It is suggested that the capital sum at the beginning of each year be treated as 100 per cent. for the average pressure at the beginning of the year and the average decline during the year will then furnish a readily usable basis for computing the depletion allowance. The amount of gas in the ground is, as a rule, to be regarded as limited to the proven territory so that as new wells are drilled and the territory is enlarged, or new gas-bearing sands are discovered, the denominator of the fraction indicating depletion varies from year to year.[32]

FORMULA.[33] The following discussion is offered for the use of those who prefer to use a formula in computing the depletion allowance. Perhaps the simplest formula may be written:

$$\frac{x}{y} \times z = \text{depletion allowance.}$$

In this formula x stands for the capital sum to the end of the year; y is the total future pressure decline or the sum of the pressures at the beginning of the tax year + the sum of the initial pressures of new wells — the sum of the pressures at the time of expected abandonment; z is the pressure decline during the year as obtained by adding to the sum of the pressures at the beginning of the year the sum of the initial pressures of any new wells completed during the year and subtracting the sum of the pressures at the end of the year. The formula may also be written as follows:

[32] Manual for the Oil and Gas Industry, p. 36.
[33] Manual for the Oil and Gas Industry, p. 37.

$$\frac{\text{Capital sum to end of tax year}}{\text{Sum of the pressures at beginning of year} + \text{the sum of initial pressures of new wells} - \text{sum of pressures at time of expected abandonment.}} \times \begin{array}{l}\text{Sum of pressures}\\ \text{at beginning of}\\ \text{tax year} + \text{sum}\\ \text{of pressures of}\\ \text{new wells} -\\ \text{sum of pressures at end of}\\ \text{tax year.}\end{array} = \begin{array}{l}\text{Depletion}\\ \text{allowance.}\end{array}$$

Gas Well Pressure Records to Be Kept. Beginning with 1919 closed pressure readings of representative wells, if not of all wells, must be carefully made and kept. In order to standardize pressure readings the well should remain closed until the pressure does not build up more than 1 per cent. of the total pressure in 10 minutes. Ordinarily 24 hours will suffice for this purpose, but some wells will need to remain closed for a longer period. If there is any water in the well it should be blown or pumped off before the well is closed. A closed pressure reading of a gas well which has been producing, or is near gas wells that have been producing, is lower than the actual pressure of the gas in the reservoir by an amount depending on the well's location with reference to other producing wells and the length of time it has been closed in. It is necessary to record the length of time the well has been closed and to show how the pressure built up during this period. Successive readings will indicate the point at which the pressure becomes approximately stationary, that is, the point at which the closed pressure approaches as nearly as possible the maximum pressure which would be shown if all wells in the pool were closed for several months. The length of time required varies with the character of the sand, position of the packer, the location of the well with reference to other wells, the limits of the pool, and other factors. The depth of the well, diameter of tubing, and line pressure when the well was shut off, should be noted. Since readings at the exact end of the taxable year will ordinarily not be available, the pressure of that date may be obtained by interpolation or extrapolation. In certain cases readings taken regularly in September or some other month may be applicable to the end of the taxable year. As a general rule September closed pressure readings furnish the best indication of depletion and it is recommended that such readings be made with regularity and care. Where interpolated or extrapolated readings are used the data from which they are obtained should be given. Gauges should be of appropriate capacity and should be frequently tested. A record should be kept of the number of

gauges, date each was tested, names of men testing, and other significant details.[34]

Computation of Depletion Allowance Where Quantity of Oil or Gas Uncertain. If by reason of the youth of the field, the restricted production, or for any other cause, it is not possible to determine with any degree of certainty the quantity of oil or gas in a property, it will be necessary to make a tentative estimate which will apply until production figures are available from which an accurate estimate may be made.[35]

Computation of Depletion Allowance for Combined Holdings of Oil and Gas Properties. The recoverable oil belonging to the taxpayer should be estimated for each property separately. The capital account for each property includes the cost or value, as the case may be, of the oil or gas lease or rights plus all incidental costs of development not charged as expense nor returnable through depreciation. The unit value of the recoverable oil or gas for each property is the quotient obtained by dividing the capital account recoverable through depletion for each property by the estimated number of units of recoverable oil or gas on that property. This unit for each separate property multiplied by the number of units of oil or gas produced within the year by the taxpayer upon such property will determine the amount which may be deducted for depletion from the gross income of that year for that property. The total allowance for depletion of all the oil or gas properties of the taxpayer will be the sum of the amounts computed for each property separately: *Provided*, That in the case of gas properties the depletion allowance for each pool may be computed by using the combined capital account returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline in rock pressures of all the taxpayer's wells in such pool in the established formula. The total allowance for depletion in the gas properties of the taxpayer will be the sum of the amounts computed for each pool.[36]

Statement to Be Attached to Return Where Depletion of Oil or Gas is Claimed. To each return made by a person owning or operating oil or gas properties, there should be attached a statement showing for each property the following information, which may be given in form of a table, if desired, by taxpayers owning more than one property:

[34] Reg. 45, Art. 212.

[35] Reg. 45, Art. 213.

[36] Reg. 45, Art. 214. For the formula referred to see Reg. 45, Art. 211; T. D. 3065, T. B. 38-20-1204.

(a) the fair market value of the property (exclusive of machinery, equipment, etc., and the value of the surface rights) as of March 1, 1913, if acquired prior to that date; or the fair market value of the property within 30 days after the date of discovery; or the actual cost of the property, if acquired subsequently to February 28, 1913, and not covered by the foregoing clause;

(b) how the fair market value was ascertained, if the property came under the first or second head under (a);

(c) the estimated quantity of oil or gas in the property at the time that the value or cost was determined;

(d) the name and address of the person making the estimate and the manner in which this estimate was made, including a summary of the calculations;

(e) the amount of capital applicable to each unit (this being found by dividing the value or cost, as the case may be, by the estimated number of units of oil or gas in the property at the time the value or cost was determined);

(f) the quantity of oil or gas produced during the year for which the return is made (in the case of new properties it is desirable that this information be furnished by months);

(g) the number of acres of producing and proven oil or gas land;

(h) the number of wells producing at the beginning and end of the taxable year;

(i) the date of completion of wells finished during the taxable year;

(j) the date of abandonment of all wells abandoned during the taxable year;

(k) a property map showing the location of the property and of the producing and abandoned wells, dry holes, and proven oil and gas lands;

(l) the average gravity of the oil produced on the tract;

(m) the number of pay sands and average thickness of each pay sand or zone on the property;

(n) the average depth to the top of each of the different pay sands;

(o) any data regarding change in operating conditions, such as flooding, use of compressed air, vacuum, shooting, etc., which have a direct effect on the production of the property;

(p) the monthly or annual production of individual wells and the initial daily production of new wells (this is highly desirable information and should be furnished wherever possible);

(q) (for the first year in which the above information is filed

for a property which was producing prior to the taxable year covered by the above statement the following information must be furnished) annual production of the tract or of the individual wells, if the latter information is available, from the beginning of its productivity to the beginning of the taxable year for which the return was filed; the average number of wells producing during each year; and the initial daily production of each well; and

(r) any other data which will be helpful in determining the reasonableness of the depletion production.[37]

MAPS. Maps that accompany records and delineate property boundaries must be sufficiently extended to show the position of property in relation to section, township, and range lines, or in areas of metes and bounds survey, the relation to two or more established lines, of either township or district. On some part of the map should be recorded the name of the state, county, township or district, name of the owner, operator and (or) lessee of the property, scale of map, and date of survey, and points of the compass. It will be to the advantage of every taxpayer to assist the department in compiling complete statistics of all development that has taken place, and maps submitted should show location of all wells that have ever been drilled on a given property. The character of each well should be indicated by appropriate symbols. Where wells have been drilled by another company or individual it is advisable to distinguish such wells by some symbol or abbreviation, explaining the symbol in a marginal note. When a taxpayer has filed adequate maps with the Commissioner he may be relieved of filing further maps of the same properties, providing all additional information necessary for keeping the maps up to date is filed each year. This includes records of dry holes as well as producing wells, together with logs, depth, and thickness of sands, location of new wells, etc. By "production" is meant the production of oil or gas belonging to the taxpayer. In those leases where no account is kept of the oil or gas used for fuel, the net production will necessarily be that remaining after the fuel used in the property has been taken out. In cases of this kind an estimate of the fuel used from each tract should be given for each year.[38]

Discovery of Oil and Gas Wells. The discovery clause of the statute provides that taxpayers who discover oil and gas wells on or after March 1, 1913, may, under the circumstances therein

[37] Reg. 45, Art. 218.

[38] Manual for the Oil and Gas Industry, p. 43.

prescribed, determine the fair market value of such property at the date of discovery or within 30 days thereafter for the purpose of ascertaining allowable deductions for depletion. Before such valuation may be made the statute requires that two conditions precedent be satisfied, (1) that the fair market value of such property (oil and gas wells) on the date of discovery, or within 30 days thereafter, became materially disproportionate to the cost, by virtue of the discovery, and (2) that such oil and gas wells were not acquired as the result of purchase of a proven tract or lease.[39] The discovery value when obtained in accordance with the rules set forth below is, in the case of a lease, to be equitably apportioned between the lessor and lessee.[40] The discovery clause was inserted to protect the prospector or "wildcatter" who goes into an unknown field and overcoming hazards of the business discovers a new and valuable deposit of oil or gas, and by so doing increases the value of his holdings to such an extent that their value at the time of the discovery or within 30 days thereafter is materially disproportionate to their cost. The discovery may refer to the opening up of a new pool or field or it may refer to the tapping of a new and previously unknown sand or zone in an old pool or field. The benefits, however, will accrue solely to the holdings of the taxpayer actually making the discovery. And it will effect him only in so far as he is able to prove that his discovery was bona fide, and that it has so increased the value of his holdings as to make it materially disproportionate to the cost.[41] Unless the taxpayer proves to the satisfaction of the Commissioner that his so-called discovery well has opened up an entirely new pool or structure or a new sand or zone in the particular pool or structure in which the operation takes place, this law will not apply to (a) any tract or lease any part of which was proven or producing prior to the date of (the alleged) discovery, (b) nor to any tract or lease within the proven limits of any well-recognized oil or gas pool or field, (c) nor to such wells as are drilled immediately in advance of producing wells, (d) or on the edge of proven territory. Neither will it apply to the tract or lease of any other than the taxpayer making the *bona fide* discovery.[42]

[39] Reg. 45, Art. 220, as amended by T. D. 2956, Dec. 2, 1919. This Treasury Decision substantially modifies the former ruling of the Treasury Department. See also T. D. 3089, T. B. 47-20-1313.

[40] Manual for the Oil and Gas Industry, p. 20.

[41] Manual for the Oil and Gas Industry, p. 45; T. D. 3089, T. B. 47-20-1313.

[42] Manual for the Oil and Gas Industry, p. 45.

DISCOVERY—PROVEN TRACT OR LEASE—PROPERTY DISPROPORTIONATE VALUE. (1) For purposes of the discovery clauses of the Revenue Acts of 1918 and 1921, an oil or gas well may be said to be discovered when there is either a natural exposure of oil or gas, or a drilling that discloses the actual and physical presence of oil or gas in quantities sufficient to justify commercial exploitation. Quantities sufficient to justify commercial exploitation are deemed to exist when the quantity and quality of the oil or gas so recovered from the well are such as to afford a reasonable expectation of at least returning the capital invested in such well through the sale of the oil or gas, or both, to be derived therefrom.

(2) A proven tract or lease may be a part or the whole of a proven area. A proven area will be presumed to be that portion of the productive sand or zone or reservoir included in a square surface area of 160 acres having as its center the mouth of a well producing oil or gas in commercial quantities. In other words, a producing well will be presumed to prove that portion of a given sand, zone or reservoir which is included in an area of 160 acres of land, *regardless of private boundaries.* The center of such square area will be the mouth of the well, and its sides must be parallel to the section lines established by the United States system of public land surveys in the district in which it is located. Where a district is not covered by the United States land surveys, the sides of said area must run north and south, east and west.

So much of a taxpayer's tract or lease which lies within an area proven either by himself or by another is "a proven tract or lease" as contemplated by the statute, and the discovery of a well thereon will not entitle such taxpayer to revalue such well for the purpose of depletion allowances, unless the tract or lease had been acquired before it became proven. And even though a well is brought in on a tract or lease not included in a proven area as above defined, nevertheless it may not entitle the owner of the tract or lease in which such well is located to revaluation for depletion purposes, if such tract or lease lies within a compact area which is immediately surrounded by proven land, and the geologic structural conditions on or under the land so inclosed may reasonably warrant the belief that the oil or gas of the proven areas extends thereunder. Under such circumstances the entire area is to be regarded as proven land.

(3) The "property" which may be valued after discovery is the "well." The "well" is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content

of the particular sand, zone or reservoir (limestone, breccia, crevice, etc.) in which the discovery was made by the drilling and from which the production is drawn, to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area.

(4) A taxpayer to be entitled to revalue his property after March 1, 1913, for the purpose of depletion allowances must make a discovery after said date and such discovery must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the output of such well of oil or gas affords a reasonable expectation of returning to the taxpayer an amount materially in excess of the cost of the land or lease if acquired since March 1, 1913, or its fair market value on March 1, 1913, if acquired prior thereto, plus the cost of exploration and development work to the time the well was brought in.[43]

Private Bounding Lines. The "private bounding lines," mentioned in subdivision (3) of the previous paragraph, refer to the *exterior limit of a continuous tract held under lease or leases or in fee by the taxpayer.* To illustrate:

A company has leases upon the S. E. quarter of the N. W. quarter of section 10. The company holds this land under five separate leases from different fee owners. A well is brought in upon the land, conceded to be a discovery well, subsequent to the acquiring of the leases by the company, and so located as to include the entire 40 acres of the company in the proven area. The property to be valued is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of this particular sand, zone, or reservoir, in which the discovery was made, to the limits of the entire 40 acres held by the company. If the "private bounding lines" were interpreted to mean the boundaries of each lease, it would enable the company to value one well subsequently brought in upon each of the five leases.

Wells drilled upon a proven tract which has already been re-valued upon discovery have no significance upon the value previously given the "property." But wells brought in upon a proven area still further extend the proven area. To illustrate:

[43] Reg. 45, Art. 220a, as amended by T. D. 2956; Manual for the Oil and Gas Industry, p. 43. The same evidence as required under "Determination of fair market value," must be submitted by the taxpayer to substantiate the value which he sets up as of date of the discovery, or within 30 days thereafter, in the cases under discussion.

A company owns an acreage of land upon which a discovery well is brought in, all of the proven area being included in the acreage. The company, for the purpose of ascertaining allowable deductions for depletion, determines the fair market value of the "well," i. e. (1) the drill hole, (2) the surface necessary for the drilling and operation of the well, and (3) the oil or gas content of the particular sand, zone, or reservoir, in which the discovery was made by the drilling, and from which the production is drawn. The great increase in value, of course, is from item (3), the oil or gas content of the sand, zone, or reservoir. If the company were allowed to value other wells brought in upon this proven area, it would in fact be valuing the same oil and gas content of the sand, zone or reservoir, which had previously been valued and upon which depletion was being taken. Such a result would be distinctly contrary to the statute. However, the bringing in of other wells upon this proven area, still further extends the proven area to the extent provided by law, and wells brought in upon an area so proven can not be revalued unless the land was acquired before proven.

If a well should be drilled in the corner of a quarter section of land owned by the taxpayer, to be able to value the portion of the quarter section not proven by the well, it would be necessary for other wells to be brought in upon the area not proven by the first well.[44]

PROOF OF DISCOVERY OF OIL AND GAS WELLS. In order to meet the requirements of the discovery clause of the statute to

[44] O. D. 527, T. B. 22-20-970. It is difficult to see the authority in the statute or any ground in equity for this ruling insofar as it precludes the taxpayer from revaluing acreage beyond the limits of the area proven by the first well by means of a well drilled in such proven area. The effect of the ruling is (1) to preclude a purchaser from claiming discovery value on the extended area proven beyond the limits of the original tract by additional wells drilled within those limits on the ground that such extended area is "a proven tract or lease" within the meaning of the law, and (2) to deny the right of the taxpayer to re-value the same extended area on the ground that as to him such extended area is not "proven" until discovery is actually made outside the limits of the original tract. There seems to be a valid reason for (1), but, if so, (2) is clearly inconsistent. The ruling, as it now stands, limits the application of the mathematical formula of a proven tract or lease according to the interest of the government. If the formula is to be applied at all, it would seem only reasonable to apply it without discrimination. It is not difficult to conceive of cases in which, on account of geological or operating conditions, a taxpayer would drain the acreage outside the original tract without being able economically to drill outside such tract.

the satisfaction of the Commissioner, the taxpayer will be required, among other things, to submit the following with his return:

(a) A map of convenient scale, showing the location of the tract and discovery well in question and of the nearest producing well, and the development for a radius of at least three miles from the tract in question, both on the date of discovery and on the date when the fair market value was set.

(b) A certified copy of the log of the discovery well, showing the location, the date drilling began, the date of completion and beginning of production, the formations penetrated, the oil, gas, and water sands penetrated, the casing record, including the record of perforations, and any other information tending to show the condition of the well and the location of the sand or zone from which the oil or gas is produced on the date the discovery was claimed.

(c) A sworn record of production clearly proving the commercial productivity of the discovery well.

(d) A sworn copy of the records, showing the cost of the property; and

(e) A full explanation of the method of determining the value on the date of discovery, or within 30 days thereafter, supported by satisfactory evidence of the fairness of this value.[45]

Charges to Capital and to Expense in the Case of Oil and Gas Wells. Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property, it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital accounts returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years.[46] Casinghead-gas contracts have been construed to be tangible assets and their cost may be added to the capital account

[45] Reg. 45, Art. 221, as amended by T. D. 2956.
[46] A. R. M. 110, T. B. 10-21-1498; O. D. 796, T. B. 6-21-1434.

returnable through depletion, following the rate set by the oil wells from which the gas is derived, or, if the life of the contract is shorter than the reasonable expectation of the life of the wells furnishing the gas, the capital invested in the contract may be written off through yearly allowances equitably distributed over the life of the contract. All oil produced during the taxable year, whether sold or unsold, must be considered in the computation of the depletion allowance for the taxable year. In computing net income all oil in storage at the beginning and at the end of the taxable year must be inventoried at cost, that is, unit cost plus lifting cost. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.[47]

Depreciation of Improvements in the Case of Oil and Gas Wells. Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for the depletion or return of capital, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under the preceding paragraph. The amount deductible on this account shall be such an amount based upon its cost or fair market value as of March 1, 1913, equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit.[48]

PHYSICAL PROPERTY. Physical property is defined as all equipment having an inventory or salvage value and subject to re-

[47] Reg. 45, Art. 223. It has been held that a subsidiary company is bound by the election made by its parent or holding company in charging development and exploitation expenses to operating expenses and may not capitalize such expenses after such election. (O. D. 1002, T. B. 34-21-1781).

[48] Reg. 45, Art. 225. See Chapter 26 for a discussion of depreciation.

moval from the property, such as buildings, bridges, and power plants, derricks, casings, drilling equipment (cable and rotary), and pumping equipment, including engines, boilers, tubing, and rods; flow lines, and connections on wells, tanks attached to wells, and other tankage of steel, wood, or concrete; cleaning and pulling equipment; salt-water equipment; refineries, treating and reducing plants, including casinghead gas plants; telegraph and telephone lines, pipe lines and tank cars, and all other equipment used in the production, reduction, conservation, or transportation of oil and gas or their products.[49]

ESTIMATES OF DEPRECIATION OF PHYSICAL PROPERTY. Some percentages and tables used in the estimation of depreciation of oil and gas property and intended as a suggestion for the guidance of the taxpayer in calculating his just tax have been prepared by the department.[50] The percentages and tables are neither maximum nor minimum rates. They are *not to be applied indiscriminately to specific property,* and the bureau is in no way committed to accept allowances based upon them. Every claim for deduction must be accompanied by a detailed statement of the facts upon which such claim is based. Each class of equipment is shown in detail and as a class, with the suggestion that an average life of the class be used rather than the life of any individual part. The average years of useful life of the various classes is shown in the summary sheet and a suggestion for charging out annual percentages to conform to the depreciation as it actually occurs. It must be borne in mind that it is not possible to make standard rules or formulae to cover all conditions in this business. Although different rates may reasonably be applied in different parts of the country, the average rates for each locality are not given by the treasury department, as it is believed that the variation of such rates from the general average is so slight as to be practically negligible in most instances. Whenever the life of the property is materially shorter than that called for in this schedule, a special rate may be claimed, or the differences may be made up by replacements chargeable to the maintenance accounts. In the case of some of the Gulf coast districts, portions of the pipe lines are eaten out in five or six years. These repairs are rightly a replacement and chargeable to maintenance or operating accounts.[51]

Depletion and Depreciation of Oil and Gas Wells in Years Before 1916. If upon examination it is found that in respect of

49 Manual for the Oil and Gas Industry, p. 9.

50 These percentages and tables are shown in the Oil and Gas Manual.

51 Manual for the Oil and Gas Industry, p. 59.

the entire drilling cost of wells, including physical property and incidental expenses, between March 1, 1913, and December 31, 1915, a taxpayer has been allowed a reasonable deduction sufficient to provide for the elements of exhaustion, wear and tear, and depletion, it will not be necessary to reopen the returns for years prior to 1916 in order to show separately in these years the portions of such deduction representing depletion and depreciation, respectively. Such separation will be required to be made of the reserves for depreciation at January 1, 1916, and proper allocation between depreciation and depletion must be maintained after that date. In any case in which it is found that the deductions taken between March 1, 1913, and December 31, 1915, are not reasonable, amended returns may be required for these years.[52]

[52] Reg. 45, Art. 226.

CHAPTER 30

DEPLETION OF TIMBER

The provision of the Revenue Act of 1921 permitting the deduction of an allowance for depletion in the case of mines, oil wells, gas wells, or other natural deposits and timber, has been set forth and discussed generally in another chapter.[1] The same allowance was permitted under the 1918 Law, and the regulations issued under that law remain still applicable. The allowance is based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto. The essence of this provision is that the owner of timber property, whether it be a leasehold or a freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to its fair market value as of March 1, 1913, plus in any case the subsequent cost of plant, equipment and development which is not chargeable to current operating expenses, but not including cutover land values.[2] The allowance is permitted to operating owners, lessors and lessees, and the capital recoverable through the depletion allowance in the case of each and the rules with respect to the apportionment of the deduction between lessor and lessee are also set forth generally in another chapter.[3] The cost of timber property is determined in accordance with the rules laid down in the same chapter.[4] Certain special rules specifically re-

[1] See Chapter 27.

[2] Reg. 45, Art. 227. Prior to the 1918 law the statute did not provide for depletion of timber lands, but the treasury department prescribed rulings under which a deduction could be taken from gross receipts or made through a charge in the cost of manufacturing the timber into lumber. These rulings were practically to the same effect as those discussed in this chapter.

[3] See Chapter 27. It has been held that since a licensee of Crown Timber Limits in the Province of Quebec has no proprietary interest in the timber, but only a right to enter upon the lands and cut and remove timber therefrom upon the payment of the prescribed dues and charges, his status is solely that of lessee and that the bonus paid by him for the privilege of obtaining the license or the value of the license on March 1, 1913, if the license was granted prior to that date, constitutes his entire depletable interest. (L. L. 1055, T. B. 49-20-1334; see also A. R. M. 111, T. B. 9-21-1480.)

[4] This chapter should be consulted in connection with the rules discussed in this chapter. Many of the rules stated in Chapter 29 on oil and gas wells have a more general application and should be consulted also.

lating to the depletion allowance in the case of timber are set forth below.

Determination of Fair Market Value of Timber. Where the fair market value of the property at a specified date, in lieu of the cost thereof, is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the commissioner upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought will be the selling price assuming a transfer between a willing seller and a willing buyer as of the particular date. Such factors as the following will be given due consideration: (a) Character and quality of the timber as determined by species, age, size, condition, etc.; (b) the quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber; (c) accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation, and the climate and the state of industrial development of the locality); and (d) the freight rates by common carrier to important markets. The timber in question will be valued on its own merits, and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned above, will be consistent with that of the other timber in the region. The commissioner will give due weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, value fixed by the owner for the purpose of the capital stock tax, valuation for local or state taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried and / or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors. For depletion purposes the fair market value at a specified date may not include any part of the value of the land.[5]

[5] Reg. 45, Art. 234.

Determination of Quantity of Timber. Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure log scale, cords, or other units) of timber reasonably known or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. This estimate must state as nearly as possible the number of units which would have been found present by a careful estimate made on the specified date with the object of determining 100% of the quantity of timber which the area would have produced on that date if all the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If, subsequently, during the ownership of the taxpayer making the return, as the net result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, and / or of errors in the original estimates, there are found to remain on the ground, available for utilization, more or less units of timber than remain in the timber account or accounts, a new estimate of the recoverable units of timber (but not of the cost or the fair market value at a specified date) must be made, and, when made, will thereafter constitute a basis for depletion.[6]

Computation of Allowance for Depletion of Timber for Given Year. The allowance for depletion of timber in any taxable year should be based upon the number of units of timber felled during the year and the unit value of the timber in the timber account or accounts, pertaining to the timber cut. The unit value of the timber for a given timber account in a given year should be the quotient obtained by dividing (a) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account into (b) the total fair market value as of March 1, 1913 (and / or cost), of the timber on hand at the beginning of the year, plus the cost of the number of units acquired during the year, plus proper additions to capital. The amount of the deduction for depletion in any taxable year with respect to a given timber account will be the product of (a) the number of units of timber cut from the given account during the year multiplied by (b) the unit

[6] Reg. 45, Art. 235.

value of the timber for the given account for the year. Those taxpayers, who keep their accounts on a monthly basis, may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year will be the sum of the amounts deductible for the several timber accounts.

The depletion of timber takes place at the time the timber is felled. Since, however, it is not ordinarily practicable to determine the quantity of timber immediately after felling, depletion, for purposes of accounting, will be treated as taking place at the time, when, in the process of exploitation, the quantity of timber is first definitely determined.[7]

In the case of timber land acquired prior to March 1, 1913, depletion may be based on the average value on that date of all timber located in a single operation unit. In other words, the average value may be determined independently for each separate operation unit. A separate operation unit should include all timber which should logically be manufactured at a single definite mill site.[8]

Revaluation of Timber Not Allowed. In the case of timber acquired prior to March 1, 1913, the fair market value as of that date should, when determined and approved by the commissioner, be the basis for determining the depletion deduction for each year during the continuance of the ownership under which the fair market value of the timber was fixed, and during such ownership there may be no redetermination of the fair market value of the timber for such purpose. However, the unit market (or cost) value of the timber will subsequently be changed if from any cause such unit market (or cost) value if continued as a basis of depletion, shall upon evidence satisfactory to the commissioner be found inadequate or excessive for the extinguishment of the cost, or fair market value as of March 1, 1913, of the timber.[9]

Charges to Capital and to Expense in the Case of Timber. In the case of a timber property held for future operation by an owner having no substantial income from the property or from other sources, all expenditures for administration, protection, and other carrying charges prior to production on a normal basis must be charged to capital account; after such a property

[7] Reg. 45, Art. 229.
[8] O. D. 43, T. B. 1-19-60.
[9] Reg. 45, Art. 230.

is on a normal production basis such expenditures should be treated as current operating expenses. In case a taxpayer, who has a substantial income from other sources, owns a timber property which is not yet on a normal production basis, he may, at his option, charge such expenditures with respect to such timber property to capital, or treat them as current operating expenses, but whichever system is adopted must be followed until permission to change to the other system is secured from the commissioner. In the case of timber operations all expenditures prior to production for plants, improvements, and equipment, and thereafter all major items of plant and equipment must be charged to capital account for purposes of depreciation. After a timber operation has been developed and equipped and has reached its normal output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current operating expenses, unless the taxpayer elects to write off such expenditures through charges for depreciation; however, the method adopted must be followed consistently from year to year.[10]

Aggregating Timber and Land for Purposes of Valuation and Accounting. With a view to logical and reasonable valuation of timber, the taxpayer must include his timber in one or more accounts. In general, each such account should include all of the taxpayer's timber which is located in one "block," a "block" being an operation unit which includes all of the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance or in which the logs or other products will probably be sold in a log or other market, the "block" may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the commissioner on audit, the taxpayer may divide the timber in a given "block" into two or more accounts, e. g., timber owned on February 28, 1913, and that purchased subsequently, may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts, or individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts, or "blocks" may be divided into two or more accounts based on the

[10] Reg. 45, Art. 231.

character of the timber and / or its accessibility, or scattered tracts may be included in separate accounts. When such a division is made a proper portion of the total value or cost, as the case may be, should be allocated to each account.

The timber accounts mentioned in the preceding paragraph may not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in the foregoing part of this paragraph the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character and / or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, will be allocated to each account.

The total value or total cost, as the case may be, of land and timber should be equitably allocated to the timber and land accounts, respectively.

Each of the several land and timber accounts carried on the books of the taxpayer must be definitely described as to their location on the ground either by maps or by legal descriptions.

For good and substantial reasons, to be approved by the commissioner, or as required by the commissioner, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.[11]

Timber Depletion and Depreciation Accounts on Books. Every taxpayer claiming or expecting to claim a deduction for depletion and / or depreciation of timber property (including plants, improvements, and equipment used in connection therewith) must keep accurate ledger accounts in which should be charged the fair market value as of March 1, 1913, or the cost, as the case may be, of (a) the property, and (b) the plant, improvements, and equipment, together with such amounts subsequently expended for the administration, protection, and other carrying charges, or development of the property or additions to plant and equipment as are not chargeable to current operating expenses. In such accounts there should be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total value or cost should be allocated to each. These accounts should be credited with the amount of the depreciation and depletion deductions claimed and allowed each year, or the amount of the depreciation and depletion should be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for deple-

[11] Reg. 45, Art. 236.

tion and depreciation equals the value or cost of the property, plus the amount added thereto for administration, protection, and other carrying charges, or development or for additional plant and equipment, less salvage value of the physical property, no further deduction for depletion and depreciation will be allowed.[12]

Information to Be Furnished by Taxpayer Claiming Depletion of Timber. To the return of the taxpayer claiming a deduction for depletion or depreciation or both there must be attached a map and statement (Form T [timber]) for the taxable year covered by the income tax return. Form T (timber) requires the following: (a) Map showing timber and land acquired, timber cut, and timber and land sold; (b) description of, cost of, and terms of purchase or lease of, timber and land acquired; (c) proof of profit or loss from sale of capital assets; (d) description of timber with respect to which claim for loss, if any, is made; (e) record of timber cut; (f) changes in each timber account as the result of purchase, sale, cutting, re-estimate, or loss; (g) changes in the physical property accounts as the result of addition to or deductions from capital and depreciation; (h) operation data with respect to raw and finished materials handled and inventoried; (i) unit production costs; and (j) any other data which will be helpful in determining the reasonableness of the depletion and / or depreciation deductions claimed in the return. Similar information is required for certain years prior to the 1919 taxable year from those taxpayers who have not already furnished it. The specific nature of the information required for the earlier years is given in detail in "Form T—General Forest Industries Questionnaire for the Years Prior to 1919."[13]

[12] Reg. 45, Art. 237.
[13] Reg. 45, Art. 233.

CHAPTER 31

NORMAL TAX CREDITS—PERSONAL EXEMPTION

Net income is ascertained by subtracting the allowable deductions from the gross income of the taxpayer. The net income so ascertained is subject to the surtax if the taxpayer is an individual, or to excess-profits taxes if the taxpayer is a corporation, but for the purposes of the normal tax of individuals and the income tax of corporations, certain items of income may be credited against net income as above ascertained. These credits are: (a) such items of income as are included in gross income but are not subject to normal tax in the case of individuals or income tax in the case of corporations (i. e., certain dividends, and interest on certain obligations of the United States); (b) the personal exemption and credit for dependents in the case of individuals and the amount of the war-profits and excess-profits taxes in the case of corporations plus $2,000 in the case of domestic corporations only,[1] and only if the net income of such corporation is $25,000 or less. Under the 1918 Law all domestic corporations were allowed a specific credit of $2,000.[2] A foreign corporation is allowed the same credits as a domestic corporation other than the sum of $2,000, under both the 1918 and 1921 Laws.[3]

Credit of Dividends Under 1918 Law. For the purpose of the normal tax only there might be credited against net income the amount received as dividends from a corporation taxable upon its net income and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax had been imposed.[4] The dividends included in the above provision of law were those received from corporations other than foreign corporations having no income from sources within the United States.[5] The normal tax did not apply to dividends, regardless of the amount of such dividends, received

[1] Revenue Act of 1921, §§ 216, 236.

[2] Revenue Act of 1918, § 236.

[3] Reg. 45, Art. 591. For a discussion of the specific credit and the credit of war-profits and excess-profits taxes allowed to corporations see Chapter 10.

[4] Revenue Act of 1918, § 216 (a). Such dividends when received by a corporation were an allowable *deduction.* (Revenue Act of 1918, § 234 (a) 6.)

[5] Reg. 45, Art. 301.

from a foreign corporation taxable upon income from sources within the United States, *however small such income might be.*[6]

Credit of Dividends Under the 1921 Law. Under the present law there is allowed as a credit against the normal tax the amount received as dividends (1) from a domestic corporation other than a corporation 80% or more of the gross income of which (computed without the benefit of this provision) for the three year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States and if, in the case of such corporation, 50% or more of its gross income (computed without the benefit of this provision) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States, and (2) from a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50% of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as defined by the statute.[7] Dividends of a foreign corporation whose income from sources within the United States was absorbed by deductions allocable to this country might be applied as a credit against net income by the stockholders of such corporation. The American stockholders of a foreign corporation whose entire income from sources within the United States consisted of dividends from a corporation taxable upon its net income under the Revenue Act of 1918 were entitled to credit for purposes of the normal tax for the dividends received from such corporation.[8] Where a town owned practically all of the common stock of a corporation organized to furnish it with water, light, power and heat, no dividends being paid thereon, the preferred stock to be redeemed as soon as pos-

[6] Letter from treasury department dated June 9, 1919; I. T. S. 1921, ¶ 1661. T. B. M. 21, T. B. 5-19-252. The credit of dividends received from foreign corporations taxable on income from sources within the United States applied equally to the Revenue Acts of 1916, 1917, and 1918. The same credit was allowed to corporations under the Revenue Act of 1917, for the purpose of the 4% war income tax imposed by § 4 of that act, but not for the purpose of the 2% tax imposed by § 10 (a), Revenue Act of 1916, as amended by the Revenue Act of 1917. (O. D. 383, T. B. 4-20-706.)

[7] Revenue Act of 1921, §§ 216 (a), 262 and 217. Such dividends are allowed to corporations as a *deduction* (Revenue Act of 1921, § 234 (a) 6).

[8] L. O. 1054, T. B. 47-20-1314.

sible out of earnings, after which the plant becomes the property of the town, the corporation is held to be exempt from income tax and dividends received by the preferred stockholders might not, therefore, be credited against net income.[9]

Credit of Interest. Both the Revenue Act of 1921 and the Revenue Act of 1918 provide that in the case of individuals, for the purpose of the normal tax only, there may be taken as a credit against net income the amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income.[10] In the case of corporations such amount may be taken as a credit against net income for purposes of income tax.[11] Consequently as to individuals, the normal tax does not apply to interest on any obligations of the United States and in the case of corporations no *income* tax is imposed on any interest received upon obligations of the United States or bonds of the War Finance Corporation.[12]

Personal and Specific Exemptions. The 1918 Law provided that for the purpose of the normal tax there might be taken as a credit against net income in the case of a single person, a personal exemption of $1,000, or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,000.[13] Under the present law a single person is allowed a personal exemption of $1,000. In the case of the head of a family, or a married person living with husband or wife, a personal exemption of $2,500 is allowed, unless the net income is in excess of $5,000, in which case the personal exemption is $2,000. It is further provided that in no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000.[14] Suppose, for example, a taxpayer married and living with his wife, but having no dependents, with a net income of $5,010. The income subject to the normal tax would be $3,010 ($5,010 — $2,500), and the tax thereon at 4% would be $100.40. But the reduction of the exemption from $2,500 to $2,000 may not operate to increase the tax by more than the amount of the net income in excess of $5,000, which in this case

9 O. D. 328, T. B. 28-19-612.

10 Revenue Act of 1921, § 216 (b); Revenue Act of 1918, § 216 (b).

11 Revenue Act of 1918, § 236 (a).

12 Reg. 45, Arts. 301, 591.

13 Revenue Act of 1918, § 216 (c).

14 Revenue Act of 1921, § 216 (c).

is $10. The tax payable would be, therefore, $110.10. A husband and wife living together receive but one personal exemption of $2,000, or $2,500 as the case may be, against their aggregate net income; and in case they make separate returns, the personal exemption may be taken by either or divided between them.[15] In the case of domestic corporations only, there is allowed, for purposes of income tax, under the present law, a specific credit of $2,000, if the net income is $25,000 or less. Applying the same principle as in the case of individuals, the tax may not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.[16] A specific credit of $2,000 was allowed to all domestic corporations under the 1918 Law.[17] Under the 1918 Law, the personal exemption was allowed in all cases to citizens and residents; a nonresident alien might secure the personal exemption in certain cases and on certain conditions.[18] Under the present law nonresident alien individuals and certain citizens who are taxed only on income from sources within the United States are allowed a personal exemption of $1,000.[19] The personal exemption may be said to be an arbitrary sum allowed for personal living and family expenses, which are not otherwise deductible.[20]

Head of Family. A head of a family is a person who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. The head of a family may be a single or married person, a widow, widower,[21] brother, sister, or other relative by blood, marriage or adoption. A widower who maintains a home and supports his daughter therein is held to be the head of a family, notwithstanding that the daughter is over 18 years of age, receives

[15] Revenue Act of 1921, § 216 (c); Revenue Act of 1918, § 216 (c).

[16] Revenue Act of 1921, § 236 (c).

[17] Revenue Act of 1918, § 236 (c).

[18] See page 782.

[19] Revenue Act of 1921, § 216 (e).

[20] Such expenses are expressly stated not to be deductible. See Revenue Act of 1921, § 215 (a). See Revenue Act of 1918, § 215 (a). See also Revenue Act of 1916, § 5 (a). The exemption under the 1918 Law of $3,500 of the compensation received by persons in active service in the military or naval forces was in addition to the personal exemption and credit for dependents (O. D. 123, T. B. 3-19-184).

[21] Reg. 45, Art. 302; T. D. 2427; T. D. 2692; Reg. 33 Rev., Art. 14.

nominal income from other sources, and is neither physically nor mentally incapable of self-support.[22] In order to meet the test of actual support and maintenance the benefactor must contribute more than half of the support and maintenance. A taxpayer who merely supplies means of support additional to the chief support of the beneficiary, is not the head of a family.[23]

In the absence of continuous actual residence together, whether or not a person with dependent relatives is a head of a family within the meaning of the statute must depend on the character of the separation. If a father is absent on business or at war, or a child or other dependent is away at school or on a visit, the common home being still maintained, the additional exemption applies. If, moreover, through force of circumstances a parent is obliged to maintain his dependent children with relatives or in a boarding house while he lives elsewhere, the additional exemption may still apply. If, however, without necessity the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support.[24]

Where a widow has a child over 18 years of age who is away from home attending school, the child having separate income in excess of $1,000 a year but insufficient to pay half the cost of its support, the balance being contributed by the mother, who maintains the home, the child having made a return claiming an exemption of $1,000, the widow is considered the head of a family, and is entitled to a personal exemption of $2,000 in making her return. The fact that a child under such circumstances has separate income or receives support from other sources does not preclude the parent from claiming exemption as head of a family, provided the child is in a material degree dependent on the parent for support.[25] A daughter who actually supports her dependent mother elsewhere than in her own home, by reason of the fact that she is unable to earn enough to support them both in the mother's place of abode or to defray their joint expenses in the daughter's place of employment, is properly classifiable as head of a family.[26] A father is entitled to the personal exemption as the head of a family if he is maintaining a home for daughters on the last day of the year

[22] O. D. 422, T. B. 13-20-1809.
[23] O. D. 775, T. B. 3-21-1397.
[24] Reg. 45, Art. 302; T. D. 2427; T. D. 2692; Reg. 33 Rev., Art. 14.
[25] O. D. 474, T. B. 17-20-886.
[26] O. D. 665, T. B. 38-20-1205.

and furnishing more than half their support, even if under the terms of a separation agreement with his wife the daughters may be living with the wife on the last day of the year.[27] A resident alien with children abroad is not the head of a family.[28]

HUSBAND AND WIFE. In the case of a married man or married woman the joint exemption replaces the individual exemption only if the man lives with his wife or the woman lives with her husband. In the absence of continuous actual residence together, whether or not a man or woman has a wife or husband living with him or her within the meaning of the statute must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or husband at a sanatorium or asylum on account of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together for the purpose of the statute, irrespective of their personal relations. A resident alien with a wife residing abroad is not entitled to the joint exemption.[29] Unavoidable absence of a wife, due to the war, did not preclude a husband from claiming the joint personal exemption.[30] The separation of a husband and wife due to the fact that the husband has been declared mentally incompetent and confined in an institution for treatment, is held to be temporary in character and consequently without effect in so far as the joint personal exemption is concerned.[31] A resident alien with a wife and children living abroad is not entitled to the personal exemption of a married person or head of a family, but is entitled to a credit of $400 for each dependent child under 18 years of age or incapable of self-support.[32]

CREDIT FOR DEPENDENTS. A taxpayer receives a credit of $400 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (a) under eighteen or (b) incapable of self-support because defective. The credit is based

[27] O. D. 754, T. B. 51-20-1354.

[28] Reg. 45, Art. 302; T. D. 2427; T. D. 2692; Reg. 33 Rev., Art. 14.

[29] Reg. 45, Art. 303; T. D. 2692.

[30] O. D. 357, T. B. 1-20-657.

[31] O. D. 603, T. B. 30-20-1089.

[32] O. D. 640, T. B. 34-20-1149. This credit for dependents was $200 under the 1918 Law.

upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit.[33] The credit for each dependent was $200 under the 1918 Law.[34] An American citizen may claim the credit for dependents irrespective of the nationality or place of residence of the dependents.[35] If a husband and wife both contribute to the support of a dependent, such credit must be taken by the one contributing the chief support and may not be divided between them.[36]

DATE DETERMINING EXEMPTION. The status of the taxpayer on the last day of his taxable year, determines his right to a personal exemption and to a credit for dependents. If then he is the head of a family, the personal exemption of $2,000 or $2,500 as the case may be, may be taken. If then he is the chief support of a dependent who is under eighteen years of age or incapable of self-support because mentally or physically defective, the credit of $400 may be taken. But an unmarried individual or a married individual not living with husband or wife, who during the taxable year has ceased to be the head of a family or to have dependents, is entitled only to the personal exemption of $1,000 allowed a single person. A husband and wife living together at the end of the taxable year may receive but one personal exemption of $2,000 or $2,500, divisible as they please, against their aggregate net income. If an individual dies during the taxable year, his executor or administrator in making a return for him is entitled to claim his full personal exemption according to his status at the time of his death. If a husband or wife so dies and the joint personal exemption is used by the executor or administrator in making a return for the decedent, an undiminished personal exemption according to the status of the survivor at the end of the taxable year may be claimed in the survivor's return. If a taxpayer makes a return for a period other than a taxable year, the last day of such period is treated as the last day of the taxable year for the purposes of the above discussion. The foregoing rules were followed by the depart-

[33] Revenue Act of 1921, § 216 (d); Reg. 45, Art. 304; O. D. 797, T. B. 6-21-1436. Prior to the 1918 Law, this exemption was limited to dependent *children*. (But see A. R. R. 551, T. B. 26-21-1707, where it was granted to an uncle.).

[34] Revenue Act of 1918, § 216 (d).

[35] O. D. 139, T. B. 4-19-220.

[36] O. D. 776, T. B. 3-21-1398.

ment under the 1918 Law but they are now embodied in the 1921 Statute.[37]

Credits to Nonresident Individuals Under the 1921 Law. Nonresident alien individuals and citizens taxed only on income from sources within the United States are allowed, for purposes of the normal tax, the same credit for dividends and interest on obligations of the United States and bonds issued by the War Finance Corporation as is allowed to citizens and residents. They are allowed, however, a personal exemption of only $1,000 and no credit for dependents.[38] The 1918 Law, which allowed the personal exemption and credit for dependents to nonresident alien individuals if the country in which the nonresident alien resided allowed the same credits to citizens of the United States, was found very difficult to administer and the above simpler provision of the present law is the result.[39]

Credits to Nonresident Alien Individual Under the 1918 Law. Under the 1918 Law, a nonresident alien individual, similarly to a citizen or resident, was entitled for the purpose of the normal tax to credit dividends from domestic or resident foreign corporations, interest on obligations of the United States, a personal exemption, and $200 for each dependent, except that, if he was a citizen or subject of a country which imposed an income tax, a personal exemption or credit for dependents was allowed him only if such country allowed a similar credit to citizens of the United States not residing in such country or if no tax was levied on citizens of the United States not residing in such country on income from such country.[40] "If such country allows a similar credit" meant if such country in imposing its income tax allowed a personal exemption or a credit for dependents, as the case might be, and allowed it without discrimination to citizens of the United States not residing in such country. "Country" included within its meaning any foreign sovereign state or self-governing colony (for example, the Dominion of Canada), but did not include a foreign municipality

[37] Revenue Act of 1921, § 216 (f); Reg. 45, Art. 305; O. D. 105, T. B. 2-19-154; O. D. 775, T. B. 3-21-1397. In the instructions appearing on the forms of individual returns for 1918 there first appeared a statement indicating that the personal exemption should be prorated if there was a change in the status of the taxpayer during the year, but the treasury department receded from this position prior to March 15, 1919.

[38] Revenue Act of 1921, § 216.

[39] Report of Senate Finance Committee on the Revenue Bill of 1921, dated September 26, 1921.

[40] Revenue Act of 1918, § 216 (d); letter from treasury department dated May 1, 1919; I. T. S. 1919, ¶ 3324.

(for example, Montreal) unless itself a sovereign state (for example, Hamburg).[41] To satisfy the requirement of a similar credit it was not necessary that the personal exemption or credit for dependents, as the case might be, should be the same as that allowed by the United States statute.[42] Where a country imposed an income tax but did not levy a tax on income derived from sources therein by citizens of the United States, a citizen of such country who was a nonresident of the United States was entitled to claim the credits for personal exemption and for dependents.[43] The status as to residence of an alien individual on the last day of his taxable year determined his right to be treated as a resident or as a nonresident for such year.[44]

The right of a nonresident alien to personal exemption and credit for dependents was contingent primarily on his citizenship. For example, a native-born Russian, especially one who had been living in the United States for a number of years, would still be regarded by this country as a citizen of Russia. This was rebuttable, however, by evidence of citizenship in Poland; and if an individual had in fact become a citizen of the new state, inasmuch as Poland was not included in the countries enumerated below, it would be necessary for him to comply with the above requirements as to proof to the Commissioner in order to secure the benefit of the exemptions provided.[45]

When Nonresident Alien Individual Entitled to Personal Exemption Under the 1918 Law. The following is an incomplete list of countries which either imposed no income tax or in imposing an income tax allowed both a personal exemption and a credit for dependents which satisfied the similar credit requirement of the statute: Albania, Argentina, Armenia, Bahama Islands, Barbadoes, Basutoland, Bechuanaland Protectorate, Belgium, Bermuda, Bolivia, Bosnia, Brazil, British Guiana, British Honduras, Bulowina, Bulgaria, Canada, Carinthia, Carniola, Ceylon, Chile, China, Cuba, Cyprus, Czecho-Slovakia, including Bohemia, Moravia and Slovakia; Dalmatia, Denmark, Ecuador, Egypt, Falkland Islands, Fiji Islands, France, Galicia, Gambia, Germany (Act of March 29, 1920), Gibraltar, Gold Coast, Goritz, Gradisca, Greece, Grenada, Guatemala, Herzegovina, Hongkong, Hungary, Istria, Jamaica, Kenya, Lithuania, Lower Austria, Luxemberg, Malay States, Malta, Mauritius,

[41] Reg. 45, Art. 382.
[42] Reg. 45, Art. 306.
[43] S. 969, T. B. 2-19-153.
[44] Reg. 45, Art. 306.
[45] O. D. 346, T. B. 30-19-642.

Mexico, Montenegro, Montserrat, Morocco, Newfoundland, Nicaragua, Nigeria, Northern Rhodesia, Norway, Nyasaland Protectorate, Palestine, Panama, Paraguay, Persia, Peru, Porto Rico, Portugal, Roumania, Russia (including Poles owing allegiance to Russia), St. Helena, St. Kitt Nevis, Salsburg, Santo Domingo, Serbia, Siam, Sierra Leone, Silesia, Somaliland Protectorate, Spain, Styria, Swaziland, Switzerland, Syria, Trieste, Tyrol, Uganda Protectorate, Union of South Africa, Upper Austria, Venezuela, Virgin Islands (Brit.), Weihaiwei, Western Pacific Islands, Zanzibar Protectorate. The following is an incomplete list of countries which in imposing an income tax allowed a personal exemption which satisfied the similar credit requirement of the statute, but did not allow a credit for dependents: Austrian Poland, Bachka, Banat of Temesvar, Croatia, Finland, India, Italy, Prussian Poland, Salvador, Slavonia, Straits Settlements (since January 1, 1920), Transylvania. The following is an incomplete list of countries which in imposing an income tax did not allow to citizens of the United States not residing in such country either a personal exemption or a credit for dependents and, therefore, failed entirely to satisfy the similar credit requirement of the statute: Australia, Costa Rica, Dutch Guiana, Great Britain and Ireland, Japan, the Netherlands, New Zealand, Sweden, Trinidad. The former names of certain of these territories are here used for convenience, in spite of an actual or possible change in name or sovereignty. A nonresident alien individual who was a citizen or subject of any country in the first list was entitled for the purpose of the normal tax to such credit for a personal exemption and for dependents as his family status might warrant. If he was a citizen or subject of any country in the second list he was entitled to a credit for personal exemption, but to none for dependents. If he was a citizen or subject of any country in the third list he was not entitled to credit for either a personal exemption or for dependents. If he was a citizen or a subject of a country which is in none of the lists, then to secure credit for either a personal exemption or for dependents he was required to prove to the satisfaction of the Commissioner that his country did not impose an income tax or that in imposing an income tax it granted the similar credit required by the statute.[46] In order that a nonresident alien might prove

[46] Reg. 45, Art. 307, as amended by T. D. 2970; O. D. 466, T. B. 16-20-864; O. D. 437, T. B. 14-20-831; O. D. 581, T. B. 28-20-1056; O. D. 300, T. B. 24-19-567; O. D. 547, T. B. 24-20-1004; O. D. 322, T. B. 27-19-603; O. D. 548, T. B. 24-20-1005; O. D. 364, T. B. 2-20-675; O. D. 605, T. B. 30-20-

that his country satisfied the similar credit requirement of the law, he should have submitted to the Commissioner a copy of the income tax laws of his native country, or an official communication from an accredited diplomatic representative of such country, showing that the country imposed no income tax, or in doing so granted similar credits required by statute.[47]

ALLOWANCE OF CREDITS TO NON-RESIDENT ALIEN INDIVIDUAL UNDER THE 1918 LAW. The benefit of the credits allowed against net income for the purpose of the normal tax might not be received by a nonresident alien by filing a claim with the withholding agent, but only by claiming them upon filing a return of income, with two exceptions as indicated in the two paragraphs next following.[48]

PERSONAL EXEMPTION OF NONRESIDENT ALIENS UNDER 1918 LAW. In case a nonresident alien was entitled to personal exemption and credits for dependents and his gross income from sources in the United States, including bond interest, did not exceed his personal exemption and credits for dependents, a certificate, Form 1001B, was required to be executed and filed with the withholding agent, if any part of the gross income was derived from interest upon bonds of a domestic corporation which contained a tax-free covenant clause. The certificate might be filed with the withholding agent at the end of the calendar year but not later than February first of the succeeding year and all such certificates were required to be attached to the annual list return, Form 1013. The amount of tax due from the withholding agent as shown by Form 1013, might be reduced by 2% of the aggregate amount of interest payments made to the non-

1091; O. D. 350, T. B. 31-19-648; O. D. 630, T. B. 33-20-1133; O. D. 765, T. B. 1-21-1372; O. D. 766, T. B. 1-21-1373; O. D. 777, T. B. 3-21-1399; O. D. 820, T. B. 8-21-1467; O. D. 894, T. B. 17-21-1597; O. D. 895, T. B. 17-21-1598; O. D. 906, T. B. 19-21-1622; O. D. 981, T. B. 30-21-1746; O. D. 935, T. B. 22-21-1664; O. D. 1003, T. B. 34-21-1782; O. D. 1004, T. B. 34-21-1783; O. D. 1022, T. B. 36-21-1804; O. D. 1054, T. B. 40-21-1854; O. D. 1055, T. B. 40-21-1855; O. D. 1125, T. B. 49-21-1961; O. D. 1126, T. B. 49-21-1962. In the case of Greece and Germany the personal exemption and credit for dependents were allowable only for 1919 and 1920 respectively. The foregoing provisions apply only to 1918 and subsequent years and have no application for the year 1917. (O. D. 301, T. B. 24-19-568). They apply to 1918, however, and in cases where an excess of tax has been paid for the year 1918, due to the official data not having been received by the Commissioner in regard to personal exemption, claims for refund on Form No. 46 should be filed with the collector to whom the income tax was paid. (O. D. 391, T. B. 5-20-718).

[47] O. D. 253, T. B. 15-19-446.

[48] Revenue Act of 1918, § 217; Reg. 45, Arts. 311 and 316.

resident alien upon tax-free covenant bonds during the calendar year, and the amount of tax represented by the certificates, payment of which was assumed on monthly list return, Form 1012, would not be included in the assessment against the withholding agent. The certificate might be filed only by a citizen or subject of the countries enumerated in a preceding paragraph as satisfying the similar credit requirement of the statute. In case tax in excess of a nonresident alien's tax liability had been withheld from interest upon bonds which did not contain a tax-free covenant clause, the nonresident alien should have filed or caused to be filed with the collector a return of his gross income from all sources within the United States, accompanied by a claim for refund on Form 46.[49]

ALLOWANCE OF PERSONAL EXEMPTION TO NONRESIDENT ALIEN EMPLOYEE. A nonresident alien employee, provided he was entitled to credit for a personal exemption or for dependents or both, might claim the benefit of such credit by filing with his employer Form 1115 duly filled out and executed under oath. On the filing of such claim the employer should have examined it. If on such examination it appeared that the claim was in due form, that it contained no statement which to the knowledge of the employer was untrue, that such employee on the face of the claim was entitled to credit, and that such credit had not yet been exhausted, such employer need not until such credit was in fact exhausted withhold any tax from payments of salary or wages made to such employee. Every employer with whom affidavits of claim on Form 1115 were filed by employees was required to preserve such affidavits until the following calendar year, and was then required to file them, attached to his annual withholding return on Form 1042 (revised), with the collector on or before March 1. In case, however, when the following calendar year arrived such employer had no withholding to return, he was required to forward all such affidavits of claim directly to the Commissioner (Sorting Division), with a letter of transmittal, on or before March 15. Where any tax was withheld, the employer in every instance should show on the pay envelope or should furnish some other memorandum showing the name of the employee, the date and the amount withheld. This rule applied only to payments of compensation by an employer to an employee.[50]

[49] Reg. 45, Art. 363 (a); T. D. 2920.
[50] Reg. 45, Art. 316.

CHAPTER 32

CREDIT FOR TAXES

The Revenue Act of 1918 was the first American income tax law to recognize and provide against the double taxation of income of an individual or corporation deriving income from sources within the United States and another country. Theretofore, a citizen of the United States doing business, for example, in Canada had been taxed upon the net income arising from that business by Canada and upon the same net income by the United States. Under the 1918 Law and the present law a taxpayer in such a position is allowed to deduct from the total tax found to be due on his entire net income the amount of tax (with certain limitations imposed by the 1921 Law) paid to Canada on the income arising in that country. The Revenue Act of 1921 provides that the credit for taxes will not be allowed in the case of certain citizens taxable under that law only on income from sources within the United States. A limitation on the amount of credit for taxes is also imposed by the present law. It is provided that in no case may the amount of credit for taxes exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year.[1] Certain other minor changes made by the present law are indicated in the following paragraphs. The privilege of taking credit for taxes paid to foreign countries and to possessions of the United States is extended to the following classes of taxpayers and to the extent indicated below.

Definition. "Amount of taxes paid during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the taxpayer claiming credit. "Foreign country" includes within its meaning any foreign sovereign state or self-governing colony (for example, the Dominion of Canada), but does not include a foreign municipality (for example, Montreal) unless itself a sovereign state (for example, Hamburg). It is held to mean the composite whole made up of

[1] Revenue Act of 1921, § 222 (a) 5.

all the subdivisions of a foreign state subject to the same central control. Each of the subdivisions, in this sense, is not a "country" but a part of a "country." The Province of British Columbia, therefore, does not come within the meaning of the term "foreign country."[2] "Any possession of the United States" includes, among others, Porto Rico, the Philippines and the Virgin Islands.[3]

Citizens of the United States. In the case of a citizen of the United States, whether resident or non-resident, the basis of the credit for taxes under the 1918 Law was the amount of any income, war-profits and excess-profits taxes paid or accrued during the taxable year to any foreign country upon income derived from sources therein, or to any possession of the United States.[4] The 1921 Law omits the words "upon income derived from sources therein."[5] Under the 1918 Law a tax paid by a citizen of the United States to the government of France and imposed on an amount fixed at seven times the rent of his residence in France (whether because he actually received no income or insufficient income from France), was considered not to have been imposed on income from sources therein.[6] If the taxpayer's books are kept on an accrual basis and his returns are so rendered, the credit for taxes paid to a foreign country is limited to taxes accrued in the taxable year for which the return is rendered.[7]

Resident Aliens. In the case of an alien resident of the United States the basis of the credit for taxes under the 1918 Law was as follows: (a) the amount of any income, war-profits and excess-profits taxes paid or accrued during the taxable year to any possession of the United States; (b) the amount of any such taxes paid or accrued during the taxable year to the country of which he is a citizen or subject upon income derived from sources therein, if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.[8] Under the present law he is allowed the credit included in (a) above and also the amount of any such taxes paid during the taxable year to *any* foreign country, if the foreign

2 O. D. 1050, T. B. 39-21-1844.

3 Reg. 45, Art. 382.

4 Revenue Act of 1918, § 222 (a); Reg. 45, Art. 381.

5 Revenue Act of 1921, § 222 (a) 2.

6 O. D. 1093, T. B. 45-21-1911. Such a tax would, however, be a proper *deduction*. See O. D. 317, T. B. 26-20-593.

7 O. 982, T. B. 7-20-743.

8 Revenue Act of 1918, § 222 (a) 2, 3; Reg. 45, Art. 381.

country of which he is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.[9]

COUNTRIES SATISFYING SIMILAR CREDIT REQUIREMENT. The following is an incomplete list of the countries which satisfy the similar credit requirement stated in the preceding paragraph: Bulgaria, Canada, Italy, Newfoundland, Salvador. The following is an incomplete list of the countries which do not satisfy the similar credit requirement of the statute: Argentina, Bahama, Belgium, Bermuda, Bolivia, Bosnia, Brazil, Chile, China, Costa Rica, Ecuador, Egypt, Finland, France, Great Britain and Ireland, Guatemala, Herzegovina, India, Jamaica, Japan, Montenegro, Morocco, New Zealand, Nicaragua, Panama, Paraguay, Persia, Peru, Portugal, Roumania, Santo Domingo, Serbia, Siam, Straits Settlements, since January 1, 1920, Sweden, Switzerland, Venezuela. The former names of certain of these territories are here used for convenience in spite of the actual or possible change in the name or sovereignty. A resident of the United States who is a citizen or subject of any country in the first list is entitled, for the purpose of the total tax due to the United States, to a credit for the amount of any income, war-profits and excess-profits taxes paid or accrued during the taxable year to any foreign country. If he is a citizen or subject of any country in the second list he is not entitled to such credit. If he is a citizen or subject of a country which is in neither list, then to secure the desired credit, he must prove to the satisfaction of the Commissioner that his country satisfies the similar credit requirement of the statute.[10] Under the 1918 Law a citizen of any country in the first list could only take a credit for such taxes paid to such country and not to any foreign country.

Nonresident Aliens. No credit for taxes is allowed to a nonresident alien under either the present law or the 1918 Law.[11]

Citizens of Possessions, Residing in the United States. Citizens of possessions of the United States residing in the United States are allowed a credit of any income, war-profits and excess-profits taxes paid during the taxable year to any possession

[9] Revenue Act of 1921, § 222 (a) 2, 3.

[10] T. D. 3060, T. B. 36-20-1186, revoking T. D. 3028, T. B. 24-20-1008, and adding Reg. 45, Art. 385. See also O. D. 580, T. B. 28-20-1056; O. D. 393, T. B. 5-20-720; O. D. 424, T. B. 13-20-813; O. D. 499, T. B. 19-20-922; O. D. 1125, T. B. 49-21-1961.

[11] See Revenue Act of 1921, § 222; Revenue Act of 1918, § 222.

of the United States.[12] The same credit was allowed to such taxpayers under the 1918 Law.[13]

Fiscal Year in Case of Individuals. If a taxpayer claiming credit for taxes makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year will notwithstanding any other provision of the statute be determined under the provisions set forth in the preceding paragraphs, and the Commissioner is authorized to disallow, in whole or in part, any such credit which he finds has already been taken by the taxpayer.[14]

Domestic Corporations. In the case of a domestic corporation (one created or organized in the United States) the credit for taxes is the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States.[15] The same credit was allowed under the 1918 Law, except that in the case of taxes paid to a foreign country they must have been paid upon "income derived from sources therein."[16] The tax imposed by the Republic of Cuba on all corporations operating sugar plantations therein, is based on production, not on income, and is in the nature of an excise tax. Domestic corporations may not credit the amount of such taxes against the total tax due the United States.[17] Certain domestic corporations, taxable only upon income from sources within the United States, are treated as foreign corporations.[18] The limitation on the amount of credit that may be taken is the same as in the case of individuals.[19]

Foreign Corporations. No credit for taxes is allowed to a foreign corporation notwithstanding that it may have established its principal business in this country.[20]

Domestic Corporations Owning Stock of Foreign Corporations. Under the 1921 Law, a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under the law) in any taxable year will be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such

12 Revenue Act of 1921, § 222 (a) 2.
13 Revenue Act of 1918, § 222 (a) 2; Reg. 45, Art. 1132.
14 Revenue Act of 1921, § 222 (d).
15 Revenue Act of 1921, § 238.
16 Revenue Act of 1918, § 238 (a); Reg. 45, Art. 611.
17 O. D. 372, T. B. 3-20-688.
18 Revenue Act of 1921, § 238 (f).
19 Revenue Act of 1921, § 238. See ¶ 000.
20 See Revenue Act of 1921, § 238; Revenue Act of 1918, § 238.

foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. The credit for taxes allowed to any domestic corporation under this paragraph, however, may in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when so used in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the secretary is given full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this paragraph will be construed to mean such accounting period.[21]

Credit for Taxes Allowed Under 1918 Law. A domestic corporation which owned a majority of the voting stock of a foreign corporation was entitled, under the 1918 Law, to credit its income, war-profits and excess-profits taxes with any income, war-profits or excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States in an amount equal to the proportion which the amount of any dividends (not deductible from gross income) received by such domestic corporation from such foreign corporation during the taxable year bore to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid. But in no case might the amount of the credit for such taxes exceed the amount of the dividends on the stock of the foreign corporation received by the domestic corporation

[21] Revenue Act of 1921, § 238 (e).

during the taxable year (and not deductible from gross income).

A domestic corporation seeking such credit was required to comply with the provisions of law applicable to credits for taxes already paid.[22]

Members of Partnerships. If an individual is a member of a partnership he is entitled to his proportionate share of any income, war-profits and excess-profits taxes paid or accrued during the taxable year by the partnership to any foreign country or to any possession of the United States. The law does not appear to make any distinction between domestic or foreign partnerships, but it has been ruled under the 1918 Law that if the member of a partnership was a resident alien he was entitled to the credit only "if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country."[23]

Beneficiaries of Estates or Trusts. Beneficiaries of estates or trusts are entitled to their proportionate shares of such taxes of the estate or trust paid during the taxable year to a foreign country or to any possession of the United States. If the beneficiary is a resident alien he is limited in the same manner as a resident alien member of a partnership.[24]

MASSACHUSETTS TRUSTS. Massachusetts trusts were regarded as associations within the meaning of the Revenue Act of 1918. In a case in which the shareholders of a Massachusetts trust owning and operating large properties in a foreign country received very low salaries and no dividends in 1920, so that their credit for income taxes paid to the foreign country exceeded their income taxes due to the United States, it was held that the trust could take no credit against its income tax due to the United States and thus secure the benefit of a credit for taxes paid on the identical income upon which income tax to the United States had accrued, for the reason that in the foreign country the income tax was not imposed upon an association as a separate entity but upon the beneficiaries, so that the taxes paid to the foreign country were the taxes of such beneficiaries and not the association.[25]

[22] Revenue Act of 1918, § 240; Reg. 45, Art. 636. In accordance with Reg. 45, Art. 611, the form to be used was Form 1118 instead of Form 1116.

[23] Revenue Act of 1921, § 222 (a) 4; Revenue Act of 1918, § 222; Reg. 45, Art. 381.

[24] Revenue Act of 1921, § 222 (a) 4; Revenue Act of 1918, § 222; Reg. 45, Art. 381.

[25] A. R. R. 643, T. B. 42-21-1872.

Conditions of Allowance of Credit. The following rulings were made under the 1918 Law: When credit is sought for income, war-profits or excess-profits taxes paid other than to the United States, the income tax return of the taxpayer must be accompanied by a form,[26] carefully filled out with all the information there called for and with the calculations of credits there indicated, and duly signed and sworn to or affirmed. When credit is sought for taxes already paid, the form must have attached to it the receipt for each such tax payment. When credit is sought for taxes accrued, the form must have attached to it the return on which each such accrued tax was based. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original or a duly certified or authenticated copy.[27]

In a case in which a domestic partnership leased certain patents to a British licensee for a fixed royalty, the British Government requiring the licensee to withhold and pay to it a British income tax on the royalty payments, the partners, in order to obtain credit for such tax paid to the British Government, were instructed to attach to the partnership return a claim for credit on Form 1118, modified throughout by substituting the word "partnership" for the word "corporation." In lieu of the required receipt or return, a copy of the receipt issued to the British licensee duly attested by the president of the British licensee was accepted. The individual members of the partnership were required to attach Form 1116 to their individual returns, accompanied by a copy of the receipt issued to the British licensee and a copy of the attesting affidavit made by the president of the British licensee.[28] Where under a foreign income tax law corporations are required to withhold a fixed percentage of the total amount of dividends paid to the stockholders in this country, such tax being withheld in a lump sum, although imposed upon the individual stockholders, the amounts withheld not being itemized by the foreign government, in lieu of the individual tax receipts required to be attached to Form 1116, the taxpayer may attach to the return on Form 1116 his affidavit showing the number of shares held during the year,

[26] Form 1116 for individuals or Form 1118 for corporations.

[27] Reg. 45, Art. 383; See O. D. 809, T. B. 7-21-1450.

[28] O. D. 583, T. B. 28-20-1059.

whether or not any of the shares held by him were acquired or sold during the year, giving dates and number of shares so acquired or sold; the total number of shares outstanding on which the dividend was declared, regardless of whether the dividend was paid to citizens of the United States or other governments; and the total dividends paid or accrued on such shares during the year, and attach to and make a part of such affidavit a certified copy of the tax receipts from the foreign tax collector showing the payment of the tax *en bloc*, with copies of any other documents which he may have that will serve to corroborate the facts set forth in such affidavit. The amount of the credit claimed should be computed by dividing the total tax withheld by the total number of shares of the corporation outstanding and multiplying this result by the number of shares held during the entire year. In the event that any of the shares were acquired or disposed of during the year, an adjustment should be made showing the amount of taxes properly allocated to the dividends received after acquisition or before disposition of the stock.[29]

When credit is claimed by an American bank for the amount of tax withheld from interest on bank deposits and paid to a foreign government by a foreign bank, there should be attached to and filed with Form 1118, an affidavit from the foreign withholding agent. The affidavit should set forth the title of the statute under which such withholding was required, the amount of interest accrued to the American bank and the amount of tax withheld and paid to the foreign government.[30]

In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to the above form. If such a bond is required, the prescribed form[31] should be used for it. It should be in such penal sum as the Commissioner may prescribe, and will be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond should be executed by the taxpayer, his agent or representative, as principal, and by sureties satisfactory to and approved by the Commissioner.[32]

29 O. D. 232, T. B. 12-19-407.

30 O. D. 671, T. B. 39-20-1213.

31 Form 1117 for individuals or Form 1119 for corporations.

32 Reg. 45, Art. 383; see also Art. 611 as to corporations. Domestic corporations claiming credit for taxes paid by a foreign subsidiary were

Redetermination of Tax When Credit Proves Incorrect. In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer must immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination must be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid will be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from such taxpayer under any other return, and any balance of such amount will be immediately refunded to him.[33]

Fiscal Year in Case of Corporations. If a domestic corporation makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year will, notwithstanding any provision of the statute, be determined in accordance with the provisions stated in the preceding paragraphs, and the Commissioner is authorized to disallow, in whole or in part, any such credit which he finds has already been taken by the taxpayer.[34]

permitted to avail themselves of subdivision (a) of this ruling, but not (b) as credit might be claimed only with respect to taxes paid (not those accrued) by foreign subsidiaries.

[33] Revenue Act of 1921, §§ 222 (b), 238 (b) and 252; Revenue Act of 1918, §§ 222 (b), 252; Reg. 45, Art. 384.

[34] Revenue Act of 1921, § 238 (d).

CHAPTER 33

METHODS AND PERIODS OF ACCOUNTING

Net income must be computed with respect to a fixed period. Usually that period is the taxable year which is the time unit for the purpose of the tax.[1] It must also be computed with respect to a definite method of accounting. It is provided that net income shall be computed upon the basis of the taxpayer's *annual accounting period* (fiscal year or calendar year as the case may be), in accordance with the *method of accounting* regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation must be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year, or if the taxpayer has no accounting period or does not keep books, the net income must be computed on the basis of the calendar year.[2]

This provision is designed to secure returns of income upon the same basis as, and in accord with, the books of the reporting taxpayers, whenever these books are kept in accordance with valid accounting practices; and facilitates the preparation of returns by the taxpayer by lessening the necessity for readjustment, and the verification of returns by revenue agents and inspectors, who will henceforth be able to compare figures more readily.

Basis of Actual Receipts. Taxpayers who (a) employ no specific method of accounting in keeping their books, (b) employ a method of accounting which does not clearly reflect the income, or (c) keep their books upon the basis of actual receipts and disbursements, will compute their net income under both the present and the 1918 Law upon the basis of actual receipts and disbursements; that is, such taxpayers will report as gross income only

[1] Reg. 45, Arts. 22, 1533.

[2] Revenue Act of 1921, § 212; Revenue Act of 1918, § 212. This provision extends to all taxpayers the privilege of reporting income upon the basis of book entries, a privilege accorded in some respects by the 1916 Law only to partnerships and corporations, at the same time changing the privilege into a requirement. (Revenue Act of 1916, §§ 8 (g), 13 (a), 13 (d).)

items actually or constructively received in cash or its equivalent, and as deductions only items paid in cash or its equivalent.[3]

Reporting Income Upon Accrual Basis. The requirement that income be reported and deductions taken upon the accrual basis is confined to taxpayers who (a) keep books, and (b) employ a method of accounting clearly reflecting their income. If such taxpayers employ a method of accounting according to which items, both of income and liability, are set up when they accrue, or are incurred, they are required to use this method of accounting as a basis for their returns of income. Mercantile corporations are required to file returns upon the accrual basis. When such corporations carry a substantial stock of merchandise, the inventories of the stock on hand at the beginning and end of the taxable year must be included in the computation and determination of net income for that period; when a business is carried on mainly through sales on credit no return of income for a taxable year is accurate and complete without considering the accounts receivable.[4] The accrual method does not apply to dividends which must invariably be reported for the year in which they are unqualifiedly made subject to the demand of the stockholder.[5]

REPORTING DEDUCTIONS UPON ACCRUAL BASIS. It is to be noted that both receipts and liabilities must be entered upon the same basis if the income of a taxpayer is to be clearly reflected. When the accrual basis is used for the computation of net income, items of gross income and deductions are both accounted for upon the accrual basis. Unless all items of gross income and all deductions are treated with reasonable consistency, a method of accounting will not be regarded as clearly reflecting income.[6] The statute uses the words "paid or incurred," or the words "paid or accrued" in connection with many of the deductions specified and it is also provided that the term "paid" for the purpose of the deductions and credits allowed by the income tax means "paid or accrued" or "paid or incurred" and that the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which net income is computed.[7]

[3] Revenue Act of 1921, §§ 212, 232; Revenue Act of 1918, §§ 212, 232.

[4] A. R. R. 217, T. B. 32-20-1115.

[5] Revenue Act of 1921, § 201 (e).

[6] Reg. 45, Art. 23.

[7] Revenue Act of 1921, §§ 200, 214 (a), 234 (a); Revenue Act of 1918, §§ 200, 214 (a), 234 (a). This subject is more fully covered in succeeding paragraphs. See also Chapter 21.

ACCRUED CHARGES. If book entries represent an actual expense or element of cost in the production of the income of the year, their amount is properly deductible, even though they have not been actually disbursed in cash or its equivalent, provided they constitute a liability against the assets of the taxpayer and provided further that the income is also returned upon an accrued basis. If in the course of its business, a corporation credits the accounts of individuals, firms or corporations with any expenses, interest, rentals, wages, etc., due them, thereby making them subject to the personal drawings of such creditors, or if expenses actually incurred are vouchered in definite amounts, and if the amounts so credited or vouchered are expenses incurred concurrently with and in the production of the income of the year, they may be deducted therefrom. The deduction of any accrued charges which if paid in cash or otherwise would not be deductible is not permitted.[8]

Methods of Accounting. Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.[9] It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of this true income. He must, therefore, maintain such accounting records as will enable him to do so. Among the essentials are the following: (1) In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year; (2) expenditures made should be properly classified as between capital and income, that is, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and (3) in any case in which the cost of capital assets is being recovered through deductions for depreciation, depletion or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be charged against the property account or the appropriate reserve and not against current expenses.[10]

[8] Reg. 33 Rev., Art. 126; T. D. 2433; T. D. 2625.

[9] Reg. 45, Art. 23.

[10] Reg. 45, Art. 24.

Inconsistent Bases not Permissible in Same Return. Where a taxpayer has income from several sources, including interest on securities, royalties on books, profits of a partnership maintaining its books on a cash basis, and income from a publishing business, he must report his income on a cash and disbursement basis, even though the books of the publishing business are kept on the accrual basis.[11]

When Items Should Be Reported. One of the most perplexing difficulties arising under a law which imposes a tax upon income with respect to a definite or fixed period of time is the question when, under a given set of circumstances, an item of income or a particular deduction should be reported. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation must be made in such manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.[12] The essence of this rule is that gross income should ordinarily be reported in the taxable year in which received by the taxpayer, unless he keeps his accounts upon the accrual basis, in which event items should be reported as accrued, according to recognized accounting practices. The application of this rule raises some of the most intricate problems connected with the income tax. It is only possible to suggest some of these problems in this chapter and to indicate the more or less tentative answers so far given to them by the treasury department and the courts. Many of the principles involved are hardly formulated; the subject is new; and the department is still feeling its way. There may be doubt as to the proper recipient of income, a doubt which can possibly only be resolved by litigation. An item of income may be received in a conditional sense, subject to a claim for its return. On the other hand, uncertainty may surround, not the *recipient* but the *amount* of income arising from a particular transaction, and there may, of course, be doubt both as to the recipient and the amount of income. The transaction producing income may be of a contingent character. Cash or its equivalent may be received by a taxpayer by virtue of a contract, the operation of which extends over a period of years, so that in the early years, and perhaps not until final consummation, will the

[11] O. D. 777, T. B. 29-20-1731.
[12] Reg. 45, Art. 221.

character of the payment received at the outset be definitely ascertained. Again, an item of income may be received in a year in which nothing connected with its production has transpired; it may be the result of activities or processes anticipating the taxable year by many years. Commercial transactions constantly involve transfers of property and payments of money the exact definition of which is contingent and dependent upon the future; the parties themselves may not know, and it may be impossible for them to know, how the transaction will result. The determination of contract rights and the settlement of business disputes frequently take place years after the efforts and activities and processes to which they relate. Finally, the taxpayer may discover for the first time in one year a gain or loss which in fact has occurred in a prior year.

These considerations affect not only gross income but also the charges incident to the production thereof. Deductions should be taken when payment of charges is made or when charges accrue, as the case may be. As a general rule, the statutory deductions are expenditures, other than capital expenditures, *connected with* the production of income.[13] The artificiality of the taxable year as a unit of time will often, if strictly adhered to, result in the reporting of deductions in one year which are connected with another year's income. Technically, they should be reported, so far as possible, in the same period with the income with which they are connected. It is, however, utterly impracticable to proceed in all cases upon the theory that losses and expenses must be charged against the income of the year in which the operation occurred giving rise to the losses and expenses.[14] This would mean that "the administration of the taxing acts would be an interminable accounting proposition."

Throughout this discussion the distinction between the constructive receipt and the accrual of income must be kept in mind. The manner in which income may be constructively received is described in another chapter.[15] Stated briefly, income is constructively received when it is credited to the account of or set apart without restriction for a taxpayer so that it may be drawn upon by him at any time.[16] The basic theory underlying the idea of constructive receipt is that the reduction of income to physical

13 Reg. 45, Art. 21.

14 S. 983, T. B. 3-19-188.

15 See Chapter 14. The attempt in this chapter is not to define income as in Chapter 14 but to discuss the question *when* is income to be reported.

16 Reg. 45, Art. 53.

possession, being a process to a large extent or entirely within the volition of the taxpayer, should be regarded as immaterial with respect to third parties such as the government. It is in effect an application of the principle that equity regards that as done which ought to be done. Income may accrue to a taxpayer without being subject to his demand or capable of being drawn on or against by him.[17]

WHERE THE RECIPIENT OF INCOME IS DOUBTFUL. It frequently happens that with respect to a particular item of income there is doubt as to the proper recipient. Thus, where a sale is made and because of claimants for commissions the seller is required by the purchaser to put a certain part of the purchase price in escrow, and thereafter certain claimants are paid directly out of said funds in escrow, the seller is not liable for income tax upon any part of the purchase price in escrow until actually received by him.[18] It has been held that income from oil royalties must be returned in the taxable year received, even though the title to the producing land and interest in the productive area are in litigation. This is true when the royalty payments are received *subsequent*, as well as when they are received prior, to the determination of the litigation.[19] Where the United States gov-

[17] Reg. 45, Art. 53.

[18] S. 1315, T. B. 6-20-725.

[19] O. D. 825, T. B. 9-21-1477; O. D. 1046, T. B. 39-21-1839. If any part of the royalty income accounted for as income in advance of determination of the litigation is ordered by the court to be paid over to another, any tax previously paid thereon will be credited against any income tax then due under any other return of the taxpayer, and any balance of the excess tax paid will be refunded if proper claim for such refund is made. These rulings are not easy to reconcile. They both adopt the taxable year of physical receipt as the test of when the payments should be reported. When the title to producing oil land is in litigation, the royalties received, in advance of determination of that litigation, therefrom are *conditionally* received. The taxpayer may never become legally entitled to them and may have to return them. In contemplation of law his position with regard to the funds is not different because he actually received them from what it would be if they were deposited in court or in escrow pending final determination of ownership. The distinction here is one of responsibility. If it is eventually decided that he is not entitled to them, he has in effect never received them. He has received a loan. If the moneys are finally awarded to him, the date of the judgment, or award, or decision vesting ownership in him, is the date when he may be said to receive them in any real sense. Before this decision they are not his property; how then can they be income to him? This ruling requires him to pay a tax upon income conditionally received, which may be taken from him, and to seek to recover the tax if it is taken from him. O. D. 825 is difficult to reconcile with the other rulings discussed in the text above, particularly S. 1315, T. B. 6-20-725; O. D. 948, T. B. 24-21-1687; O. D.

ernment took over a business in 1914, operating it until 1920, paying over earnings from 1914 to 1917 in 1919 upon the settlement of a dispute as to the ownership of the corporation, it was held that the sums paid over in 1919 constituted income for 1919 when they were paid over upon the settlement of the dispute.[20]

INCOME CONDITIONALLY RECEIVED. Closely related to the cases discussed in the preceding paragraph are those cases in which items of income are received in a conditional sense, subject to a claim for their return.[21] Where certain corporations collected commissions in excess of the schedule of commissions sought to be established by one of the executive departments of the government, a restraining order was issued enjoining the putting into effect of the schedule until final determination of the case. The order required that each of the corporations seeking relief should deposit with the court such portion of the commissions collected by them in excess of the commissions specified in the department's schedule. It was held that the commissions so deposited need not be returned as gross income until the taxable year in which the ownership therein was judicially determined.[22] When property is sold by individuals who are under agreement to incorporate at a later date, the proceeds of the sale being placed on deposit in a bank in escrow under the condition that the sale must be ratified by the directors of the corporation when organized, income accrues to the corporation at the time when the sale is ratified and the funds in escrow are made available to the company.[23] Where the employees of a corporation subscribe to shares of its stock, title to the stock remaining in the corporation until the stock is fully paid for, the dividends being credited to the account of the employee as part payment, such credits are not income to the employee until the terms of the agreement of subscription have been completed.[24]

WHERE THE AMOUNT OF INCOME IS DOUBTFUL. The amount of income incident to a particular transaction may remain un-

980, T. B. 30-21-1743, and O. D. 282, T. B. 21-19-523. On principle it is certainly inconsistent with the decision of the court in Holbrook v. Moore, T. B. 17-21-1592.

[20] O. D. 948, T. B. 24-21-1687. Here the company kept its books on a cash receipts and disbursements basis.

[21] An example of such a payment will be found in O. D. 19, T. B. 1-19-31. See paragraph "Payments of Compensation" below.

[22] O. D. 980, T. B. 30-21-1743.

[23] O. D. 282, T. B. 21-19-523.

[24] O. D. 763, T. B. 1-21-1370; O. D. 791, T. B. 6-21-1426. See A. R. R. 182, T. B. 29-20-1070.

determined for a considerable period after the transaction from which it originated. In other words, a claim may remain unliquidated for some time after it arises. This was particularly true in the period of unusual conditions prevailing at the close of 1918 when it was recognized that many items of gross income such as claims for compensation under cancelled contracts together with claims against contracting departments of the government for amortization and other matters, while properly constituting gross income for the taxable year 1918 were undecided and not sufficiently definite in amount to be reported in the original return for that year.[25] All such claims have been held in the final analysis to be more or less tentative and subject to revision and where the full amount of such claims has been reported as income, the loss resulting from the disallowance of part thereof can not be classified with bad accounts.[26] Applying this rule, it has been held that where a number of carloads of coal, purchased on contracts entered into prior to October 30, 1919, and shipped to tidewater for export, were diverted by the Fuel Administration for the account of the Railroad Administration, and settlement with the railroads receiving the coal remained undetermined, the railroads having remitted some on the basis of the maximum government price and some on the basis of the cost price, the corporation owning the coal should set up the accounts involved in a "suspense account" and eliminate them from its 1919 and 1920 returns pending final settlement when amended returns might be made for these years.[27] But where an item is in dispute and there is no assurance that it will be paid, it should not be reported as income until there is an adjudication that it is due, or a settlement of the dispute.[28] Thus an award in the year 1918 by a board of arbitration on an unliquidated claim to a portion of the proceeds arising out of transactions which took place in 1917, is held to be income for the year 1918 rather than 1917.[29] The amount of compensation for

[25] Reg. 45, Art. 52, as amended by T. D. 3247, T. B. 48-21-1943. These provisions are not applicable to cases in which collections of taxpayers for the year 1920 have been postponed because of unusual conditions such as the moratorium in Cuba, there being no question as to the definiteness of the obligations of purchasers. (O. D. 869, T. B. 15-21-1559.)

[26] A. R. R. 685, T. B. 48-21-1948.

[27] O. D. 816, T. B. 8-21-1461. It was also held that the corporation should attach to its original 1919 and 1920 returns a full statement of facts relative to the claims. (See next footnote.)

[28] Sol. Op. 41, T. B. 34-20-1159; O. D. 642, T. B. 34-20-1151.

[29] S. 1335, T. B. 8-20-750. See O. D. 591, T. B. 29-20-1071; O. D. 642, T. B. 34-20-1151. In this case prior to the award there was doubt as to whether

personal services is frequently doubtful as in a case where such amount is largely in the discretion of the employer or where it is contested.[30]

WHERE THE TRANSACTION PRODUCING INCOME IS CONTINGENT. Question as to when an item should be reported sometimes arises in connection with exchanges of property. When is the exchange a closed transaction? Where in connection with the reorganization of a company the stockholder has the right to make an exchange in one year but does not actually make the exchange until the following year, the profit accruing is income in the year in which the exchange is actually made.[31] In a case in which holdings of stock in a corporation, including shares held prior to March 1, 1913, shares received as dividends after March 1, 1913. and shares acquired by purchase after March 1, 1913, were in 1918 exchanged for shares of stock in several other corporations, but owing to requirements of the capital issues committee, a portion of the stock to be received was held in trust during the period of the war, certificates of ownership being issued and final delivery of the stock being made in 1919, the treasury department held that the exchange constituted a closed transaction which reflected a gain or loss in the difference between the aggregate value of the shares exchanged and the total market value of the securities received, and that the date of the exchange and not the date of complete delivery determined the taxable period in which such gain or loss should be reported.[32] A sale may be of a contingent character depending for final consummation upon events taking place in a year following. Thus, a corporation engaged in the exportation of merchandise made heavy shipments to foreign countries during 1919. The bill of lading in each case

or not the taxpayer would receive anything, and the award was regarded as equivalent to a judgment. The outcome of the controversy was so uncertain that it could not possibly have been foretold. The case does not seem entirely consistent with the coal case discussed in the text above. In that case there seemed to be considerable doubt as to the amount which the owner of the coal would receive. It is true, however, that the corporation owning the coal was practically certain of receiving something. These two cases illustrate the difficulty inherent in these questions of when income should be reported. Strictly speaking, insofar as the amounts received for the coal were contingent and subject to the possibility of not being received, they should have been reported when the determination was made, that the sums were owing to the taxpayer, the amounts not in controversy being reportable in the earlier years under amended returns.

30 These cases are discussed below. See paragraph "Payments of Compensation."

31 A. R. R. 289, T. B. 44-20-1274.

32 O. D. 480, T. B. 18-20-892.

was accompanied with a draft on a bank located in the city of the purchaser, the understanding being that legal title to the goods should not pass prior to the acceptance of the draft by the purchaser. Many of the drafts so sent were not accepted and the goods were sold to persons other than the original purchasers. In numerous cases these rejections did not take place until after the close of the year 1919 and notice of the nonacceptance was not received prior to the filing of the corporation's 1919 return. The corporation reported in its return for 1919 the profits to be realized upon all such sales within the year and excluded the goods so sold from its closing inventory for 1919. This was held to be an error. No part of the profit to be realized upon any particular sale made in 1919 should have been included in the income of the corporation for that year if at the end of the year the company was not in receipt of notice of the acceptance of the draft accompanying the bill of lading for such sale. The goods so shipped, but not considered as having been actually sold, because of the nonacceptance of the draft or because of the nonreceipt of a notice of the nonacceptance of the draft should have been included in the closing inventory for 1919.[33] It is held also that a corporation is not required to treat its contracts covering unfilled and undelivered orders for its goods as gross sales for the year in which an order is taken and a contract entered into, but that the sale of the goods can not be properly considered as taking place when the goods are delivered to the carrier for shipment to the buyer, or in those cases in which the purchaser is to call for the goods at the place of business of the seller, until there is a specific identification of the goods manufactured and they are put in a deliverable state.[34]

PAYMENTS THE CHARACTER OF WHICH DEPENDS ON FUTURE DEVELOPMENT. Cash or its equivalent may be received by a taxpayer by virtue of a contract, the operation of which extends over a period of years and the exact nature of early payments may remain doubtful until the contract is finally performed. Sums received may prove ultimately to be a return of capital or income, according to future developments. For instance, a corporation assigned its principal asset, a mortgage, to trustees in trust for its stockholders and then instituted liquidation proceedings. The mortgage was payable in annual installments

[33] O. D. 824, T. B. 9-21-1476. The question of notice would seem to be immaterial in this case; the real question was: Was there a sale? not, Did the taxpayer know whether or not there was a sale? Compare this decision with O. D. 13, T. B. 1-19-25.

[34] O. D. 826, T. B. 9-21-1478.

with interest, and the beneficiaries were to receive proportionate shares of the principal and interest as paid to the trustees. The trustees were to receive compensation in a fixed amount plus a percentage of the income received and distributed, and be reimbursed for expenses incurred in connection with the trust. It was held that the profit of the stockholders from the surrender of their stock is not definitely ascertainable, and they need not report any amount as income until the total sum received in liquidation exceeds either the cost of their stock or its fair market value March 1, 1913, if acquired prior to that date.[35]

SUBSEQUENTLY DISCOVERED GAINS. A taxpayer some times discovers for the first time in one year a gain which has in fact occurred in a prior year. Thus, adjustments made in accordance with instructions from the Interstate Commerce Commission, increasing the income of a railroad corporation from transactions in prior years and taken up on the books of the corporation during the taxable year because necessary information was not available prior to that time, represent income for the years during which the transactions took place instead of the taxable year. Corrections should be made by means of amended returns.[36] Profit on goods sold by a consignee is income to the consignor for the year in which the sales are made, even though the consignor received no notification of sale until a subsequent year. If reported otherwise, amended returns should be filed.[37]

PAYMENTS OF COMPENSATION. The well established rule that compensation for personal services is to be reported as income in the year of receipt, rather than the year in which the services for which the compensation is paid are rendered, is discussed in full in another chapter,[38] particularly as this rule is affected by the consideration that such services may have been rendered prior to March 1, 1913. This rule is productive of many artificial results.[39] It is founded, no doubt, upon the consideration that

[35] O. D. 461, T. B. 16-20-874.

[36] O. D. 9, T. B. 1-19-18.

[37] O. D. 13, T. B. 1-19-25. A loss may likewise be discovered years after it has been sustained. See Chapter 25.

[38] See Chapter 15. See also T. B. R. 12, T. B. 3-19-178; A. R. R. 182, T. B. 29-20-1070; O. D. 717, T. B. 45-20-1289; O. D. 432, T. B. 14-20-824; O. D. 19, T. B. 1-19-31; O. D. 512, T. B. 21-20-948; O. D. 456, T. B. 26-21-1700; Jackson v. Smietanka, 267 Fed. 932; affirmed Jan. 1921, T. B. 14-21-1545; Holbrook v. Moore, T. B. 17-21-1592; Woods v. Lewellyn, 252 Fed. 106; State ex rel. Houghton v. Phelps (Wis.), 176 N. W. 217.

[39] Thus an amount received on January 1st is reported as income for the year in which received rather than the year preceding during which the services which the payment represents were rendered. Again, an adver-

the recipients of salaries rarely keep books and consequently are required to report income upon the cash and receipts basis. But it is also founded in large part upon the doctrine of constructive receipt. There seems to be no valid reason under the present law (or the Revenue Act of 1918) why a taxpayer keeping satisfactory books of account and employing a regular method of accounting in keeping such books should not report payments for compensation upon an accrual basis. In regard to such payments, however, the distinction between accrual and constructive receipt is particularly important. It is well established that where compensation for personal services is contested, the entire amount thereof should be reported as income in the year in which received.[40] The same is true if the amount of compensation is in the discretion of the employer or of the amount of compensation remains undetermined until the year of payment.[41]

Allocation of Income from Judgments. Lands which are received as compensation for services in one year, the title to which is disputed and in a later day adjudged to be valid, constitute income to the grantee in the former year. On the other hand, a person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for a patent infringement. Bad debts or accounts charged off subsequently to February 28, 1913, because of the fact that they were determined to be worthless which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered.[42] Where a company in 1912 entered into an agreement to sell oil

tising solicitor is required to report commissions in the year in which received, which he may subsequently be obliged to pay back owing to failure of payment for advertising (O. D. 19, T. B. 1-19-31). A taxpayer who had been discharged from the employ of a railroad company and who was thereafter reinstated and paid for all time lost during the period of two years has been required to report the amount so received as income for the year in which paid (O. D. 512, T. B. 21-20-948). "Post allowances" made to members of diplomatic and consular services have been held to be income in the year in which received and not the year to which they related. (O. D. 997, T. B. 34-21-1778).

[40] O. D. 432, T. B. 14-20-824.

[41] O. D. 717, T. B. 45-20-1289, superseding O. D. 460, T. B. 16-20-858; Reg. 45, Art. 32. This was true in the case of Jackson v. Smietanka, 267 Fed. 932, affirmed January, 1921, T. B. 14-21-1545. But Jackson kept no books and the decision might have been placed on that ground.

[42] Reg. 45, Art. 52, as amended by T. D. 3247, T. B. 48-21-1943; Letter from treasury department dated February 11, 1916, I. T. S. 1918, ¶1211.

to another company, at 90 cents per barrel, delivery to extend over two years, the latter company to have an option to extend the term of the contract and to pay for oil thereafter delivered at a price equal to the highest contract price then being paid by any one of four of the largest purchasing companies, and did exercise such option and dispute arose as to the price to be paid, the buying company paying only 50 cents a barrel and the selling company claiming $1.00 a barrel, the price being finally fixed by the courts in 1912 at $1.00 and the buying company ordered to pay the balance of 50 cents a barrel, it has been held that such balance is income to the buying company for the year in which received and not for the year or years in which the right of action accrued.[43]

ALLOCATING DEDUCTIONS TO INCOME WITH WHICH THEY ARE CONNECTED. A taxpayer making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities.[44] Many of the principles governing the allocation of deductions to the proper taxable period are the necessary corollaries of the rules governing the allocation of items of income to their proper taxable period. Generally speaking, if a payment is income to the recipient, it is deductible, by the payor, if at all, in the period as of which it is to be reported as income by the payor.[45] It has been stated that compensation for personal services is generally to be reported by the recipient as of the period during which its amount is fixed and paid. The same item is usually to be deducted by the taxpayer as of the same

For this rule in the case of bad debts charged off as worthless prior to March 1, 1913, see Reg. 45, Art. 87, as amended by T. D. 3206.

[43] Sol. Op. 11, T. B. 34-20-1159. See Jackson v. Smietanka, 267 Fed. 932; T. D. 2960.

[44] Reg. 45, Art. 111.

[45] This will not be true in all cases. Thus a receiver of a corporation may deduct receivers' and attorneys' fees actually paid during the year to which the return relates if the books are kept on the cash receipts and disbursements basis; but if the books are kept on an accrual basis the amount of such fees accruing during the year may be deducted even though disbursement is not actually made until the following year. (O. D. 3, T. B. 1-19-6). In other words, the same item may be reported in different taxable periods by payor and payee, when the books of the one are kept on one basis and the books of the other on another basis.

period. Thus, when additional compensation is agreed to be paid by a corporation to its officers at a future date, upon the happening of certain contingencies expected to result from the rendition of services, the amount of such compensation being left for future determination, the amount eventually paid is not to be treated as back salary and allocated to the years during which the services were rendered, but constitutes a business expense to the corporation for the taxable year in which the same was paid.[46] Similarly, it was stated in discussing the subject of income that where the amount of an item was unliquidated or in controversy, it should not be reported upon final liquidation as of the year in which liquidated and paid, but should form the basis of amended returns for prior years, unless the outcome of the liquidation or controversy was so uncertain that it could not possibly have been foretold.[47] Charges should likewise form the basis of amended returns for prior years unless the outcome of the liquidation or controversy was so uncertain until final settlement that it could not have been known in advance. This is illustrated by the case of a corporation which sold merchandise, the weight and grade of which was guaranteed under contract. Under the practice of the trade, when shipments failed to conform to specifications, adjustments were made in accordance with rules promulgated by certain trade associations. Referring to certain shipments made toward the close of a taxable period and finally adjusted after the end of the taxable period, it has been ruled that if the liability of the taxpayer were in question, there would have been no deductible loss until such liability had been actually determined, either by agreement or in the courts, but where such liability is not in dispute and the amount thereof is merely an accounting detail to be determined under an existing contract or agreement, and in accordance with a clearly recognized course of procedure, such adjustments are applicable to the year in which the sales were made and should be regarded more truly as adjustments of the selling price rather than as rebates or allowances. It is held, however, that loss sustained as the result of the return of defective goods in one year, which had been sold in a prior year, is deductible only in the year in which the goods were returned.[48] Where rental is withheld by

[46] A. R. R. 232, T. B. 33-20-1130. See p. 000.

[47] See page 805.

[48] A. R. R. 275, T. B. 42-20-1242; O. D. 642, T. B. 34-20-1151; O. D. 1067, T. B. 42-20-1871. The first of these rulings may be theoretically sound, but it draws rather a fine line. When is the determination of liability under a contract merely a matter of accounting detail? This question may be an-

a lessee and held in reserve, the amount so retained is deductible for the year of withholding, although not paid in cash. Such rental is a definite liability.[49] Where the final outcome of a controversy is uncertain, the amount finally determined as a liability should be reported as of the year of final determination. Where a corporation in 1919 pays liquidated damages to be relieved from the terms of a contract which called for the delivery of merchandise in 1918 and 1919, the loss so incurred is deductible from gross income for the year 1919 rather than 1918.[50]

JUDGMENTS AGAINST TAXPAYER. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise.[51] The principle underlying this rule is that the loss or expense involved in and culminating in a judgment can not be properly set up as liabilities on the books of the taxpayer until they have become known and definite, which does not happen in a litigated matter until judgment.[52] This rule applies to all amounts paid pursuant to a judgment recovered in a patent infringement suit, whether as "damages" or as "profits turned over to the patent owner".[53] The judgment is the adjudication fixing the amount due. The report of a master in chancery, appointed by an interlocutory decree in a suit for damages for alleged infringement of a patent, assessing damages against the taxpayer, which report was filed during the taxable year, but was not confirmed until the following year when judgment was entered on the report, can not be regarded as a determination of the amount of the claim, and no deduction for the taxable year is permissible in regard to the judgment referred to.[54] The award of a board of arbitration, provided it is final, is analogous to the

swered readily enough in some cases, but there are many cases in which the whole question of liability under a contract is a matter of accounting detail; accounting details are frequently of the most vital importance going to the question of liability itself, as distinguished from extent of liability. Accounting details may change a liability into an asset.

49 O. D. 794, T. B. 6-21-1430.

50 S. 983, T. B. 3-19-188.

51 Reg. 45, Art. 111. This subject is more fully discussed in Chapter 25 on Losses, particularly under the paragraph heading "Loss due to Adverse Judgment."

52 O. D. 917, T. B. 20-21-1638.

53 O. D. 917, T. B. 20-21-1638.

54 S. 923, T. B. 1-19-94.

judgment of a court; it is a less formal, but equally conclusive determination of the rights of the parties involved.[55]

Reserves to Meet Liabilities. The extent to which reserves to meet liabilities are deductible is a difficult matter to determine. The character of the reserve is vital to any consideration of the question. If the reserve is for a liability certain and definite in amount, such as rent and interest charges incurred but payable in the future, it is deductible. Where pursuant to the consistent practice of accounting of a corporation, or pursuant to the requirements of some federal, state or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amounts of which, and the date of payment or maturity of which are not definitely determined or determinable at the time the liabilities are incurred, the treasury department permitted the amounts credited to such reserves to be deducted, under the 1916 Law, provided the amounts deductible on account of the reserves approximated, as nearly as could be determined, the actual amounts which experience had demonstrated would be necessary to discharge the liabilities incurred during the year, for the payment of which additions to the reserves were made. If it was found that the amount credited to any such reserve was in excess of the reasonable or probable needs for which the reserve was created, the excess would be disallowed as a deduction and restored to income. In no event are sinking funds or other reserves set up to meet additions, betterments or other capital obligations allowed as deductions. Reserves to meet losses contingent upon shrinkage in values, losses from bad debts, losses from capital investments, etc., are not allowable as deductions, since such losses are only deductible when definitely determined as a result of a closed or completed transaction and actually charged off.[56]

The distinction between the kind of reserves deductible and nondeductible under this ruling is difficult to define. As in the case of other rulings discussed in this chapter, the attempt again seems to be to draw a line between reserves to meet losses or

[55] See S. 1335, T. B. 8-20-750.

[56] T. D. 2433. The treasury department has always held, in the case of corporations, that it was immaterial whether deductions, except for taxes and losses, were evidenced by actual disbursements in cash, or evidenced in such other ways as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets, except that taxes were deductible only when actually paid, and not merely entered as a charge, and losses when actually sustained in the year charged off.

charges which may or may not eventually be payable at all, and as to which the question of liability remains unsettled, and losses or charges merely contingent or indefinite as to their amount.[57] This is illustrated by a ruling in regard to amounts set aside by canners of perishable fruit products against which to charge losses due to climatic and other natural conditions producing shortage of the raw products.[58] The treasury department held in this connection that in general the statute evidences a clear intent to restrict within the narrowest limits deductions for additions to reserves other than the reserves of insurance companies required by law; that it is doubtful even whether a reserve against an incurred but unpaid liability can be recognized. when the liability is at all indefinite; but there can be little doubt that a reserve against a future loss is unrecognized by the statute, and no doubt at all that a reserve against fluctuations in future profits has no standing of a kind which would warrant the deduction of additions thereto in computing net income for purposes of taxation.[59] In the light of this distinction it is interesting to note the ruling of the treasury department that where a reserve representing the estimated amount of claims which will be paid on account of loss and damages to freight and injuries to persons is adjusted at the end of the year so that the balance approximates as nearly as possible the amount of the claims actually outstanding at the close of the year, such reserve covers a contingent liability and is only deductible for the year when the claims are put in judgment or paid.[60] Amounts paid on account of loss and damages to freight and injuries to passengers may be regarded in one sense as "losses" and in another

[57] This is a shadowy distinction. Until the *amount* of a charge is determined, it is never an absolute liability. The analysis of details may reverse the entry.

[58] T. B. R. 13, T. B. 3-19-187.

[59] See A. R. M. 136, T. B. 31-21-1754.

[60] O. D. 879, T. B. 16-21-1578. Is the point of this ruling the fact that the adjustment of the reserves at the close of the year left the reserve at an amount which approximated the "*claims*" (as distinguished from the actual liability) outstanding at the end of the year? If in fact the adjustment placed the reserve at an amount which approximated the *liability* of the company, according to extended experience, and not the amount of claims outstanding a portion of which would never be paid, the ruling would seem to neglect the fact that such claims may be reduced, upon a sort of actuarial basis, to a close approximation to the amount of actual liability eventually to be paid. In other words, some of the total number of claims outstanding will never be paid; the amounts of others will be reduced; but it is possible, where the claims are numerous, to compute the amount eventually payable with comparative certainty.

sense as more or less fixed "expenses." If regarded as losses, they are not deductible until "sustained." Each loss is sustained if regarded separately when put in judgment or paid.[61] But the losses, when regarded in bulk, may be said to be sustained to the extent of a proportion of their total, based on previous experience, when the transaction or event upon which they are founded occurs. Approved standard accounting methods which are intended to control the reporting of income and deduction of losses[62] certainly dictate the allocation of such losses and charges to the year in which they originate. Where embezzlement by a bonded employee occurs, the claim against the bonding company is held the equivalent of cash and to the extent of such claim there is no loss, even though recovery against the bonding company is postponed until the following year. Recoverable insurance always reduces a loss, even though no collection thereon is made until a subsequent year.[63] If the taxpayer in such cases is considered to be in receipt of his insurance when his loss occurs, even though the insurance is not paid until a later year, it would appear that the converse proposition must be true and the insurance company must have suffered a loss in the year of embezzlement and not the year when the insurance is paid. The standing of a railroad or other company subject to claims for losses and damages to freight and injuries to passengers is not dissimilar in principle from the position of the insurance company. If the amounts of such loss and damages are regarded, on the other hand, as "ordinary and necessary expenses", and owing to their regularity and certainty there is much to be said for regarding them in this light,[66] they may be said to be deductible without reference to a strict construction of the word "sustained", such as trading stamp reserves are now held deductible.[65] Again, in the case of a taxpayer who sells automobiles on term contracts in order to insure himself against losses through em-

61 The distinction is to be noted between the phrase "losses sustained during the taxable year" (Revenue Act of 1918, §§ 214 (a) 4 and 234 (a) 4) and "losses *actually* sustained and charged off within the year" (Revenue Act of 1916, § 12 (a)). The former phrase opens the door to a more liberal and reasonable interpretation of the word "sustained".

62 Reg. 45, Art. 23.

63 Sol. Op. 845, T. B. 6-19-279; T. B. M. 55, T. B. 18-19-482.

64 Brown v. City of Corry, 175 Pa. St. 528, 34 Atl. 854. The evidence of such claims is inevitable; no railroad can be operated without the certain expectation that such claims must be met.

65 See Reg. 33 Rev., Art. 141, revised by Reg. 45, Art. 88. See also the ruling in regard to reserves for cash discounts which is not entirely consistent therewith in principle (O. D. 146, T. B. 4-19-228).

bezzlement of the cars or confiscation thereof by the government under the Volstead Act, has adopted a plan of carrying his own insurance, by collecting premiums from the purchasers under the leases or term contracts and placing the money received into a reserve fund, against which all losses referred to are charged, it has been held that if the taxpayer's books are kept on a cash receipts basis, all amounts received from the so-called premiums in any taxable year should be reported as income in the return of the taxpayer for that year, or if his books are kept on the accrual basis, then in the year in which such amounts accrue, the losses sustained by the taxpayer being allowable deductions for the year in which such losses are sustained.[66]

These rulings illustrate the uncertainty surrounding the entire subject of reserves to meet liabilities and the tentative state of the regulations relating thereto. The subject is also affected by the new provision of the Revenue Act of 1921 that losses may be deducted in a period other than that in which sustained if necessary in order clearly to reflect incomes.[67] This provision is obviously a delegation of power to the Commissioner which will enable him to permit the deduction of losses and reserves therefor, without the limitation imposed by the word "sustained."

MONEY PAID UNDER MISTAKE OF FACT. It not infrequently happens that events subsequent to an expenditure prove it to be excessive or insufficient in amount. The parties act at the time of payment under a mistake of fact. For instance, during the years 1915, 1916, and 1917, a company paid customs duties on foreign merchandise imported, on the basis of an exchange rate in excess of the rate prevailing at the time of importation. During the year 1919 the company received a refund of the amount so paid in excess of the amount due, and the question was raised as to whether the amount of the refund was properly reported as income for 1919. It was held that the excess duties for which a refund was received had been erroneously deducted in computing net income for the years 1915, 1916, and 1917, respectively, and did not represent income for the year 1919. Accordingly amended returns for the respective years should be filed.[68]

SUBSEQUENTLY DISCOVERED CHARGES. It has been held that liabilities discovered subsequently to the close of a taxable period may not be deducted for such taxable period even though they clearly relate thereto. Thus, an additional surtax imposed by the

66 O. D. 1106, T. B. 47-21-1929.

67 See Revenue Act of 1921, §§ 214 (a) 6, 234 (a) 4.

68 O. D. 741, T. B. 49-20-1332.

laws of Wisconsin retroactively for the year 1920 has been held not to be deductible under the federal law for the calendar year 1920, because such surtax was not a known liability when the books of the taxpayers liable to such tax were closed for 1920. Such surtax was held deductible in the year in which paid or in which accrued, if the books of the taxpayers were kept on an accrual basis.[69]

ALLOCATION OF DEDUCTIONS TO MORE THAN ONE YEAR. Deductions may under certain conditions be ratably distributed over more than one year by a taxpayer keeping accounts on the accrual basis. In the case of a partnership keeping its books on the accrual basis which was required to pay an injured employee a sum in weekly installments extending over several years it was held that the entire sum payable is not such an item as may be properly accrued in its entirety upon the books of the partnership at the time the award was rendered for the purpose of claiming a deduction in computing net income. Only the installments actually accrued by time elapsed whether paid or unpaid as at the end of the taxable year, are properly deductible in computing net income for that year.[70] Again, the entire amount of a reserve, set aside under the Ohio Workmen's Compensation Law, which provides for the payment of compensation in weekly installments but which also provides for the making of an award covering total liability in death and permanent disability cases, would be allocated to the years in which actually paid and may not be deducted in its entirety in the year in which determined.[71] A sum paid in 1920 by a lessee for the privilege of securing a lease to be effective in 1922 is a proper charge against the business of the taxpayer for the period between the payment thereof and the effective date of the lease, and should be apportioned over that period.[72] An amount paid by a baseball club to another baseball club as the purchase price of a contract between such club and a player covering the services of the player for a period of more than one year is deductible from gross income during the life of the contract, a proportionate part of the price paid being deductible each year.[73] Where the amount recoverable or

[69] O. D. 1118, T. B. 48-21-1949. This ruling seems contrary to the well established principle that statutory deductions being expenditures connected with the production of income should be reported so far as possible in the same period with the income with which they are connected. See p. 807. See also footnote 33.

[70] O. D. 686, T. B. 42-20-1243.

[71] O. D. 992, T. B. 33-21-1768.

[72] O. D. 1013, T. B. 35-21-1793.

[73] O. D. 836, T. B. 10-21-1494.

payable under a contract may not be accurately estimated in advance, however, and may vary in amount in the several years of performance of the contract, such amount may not be amortized over the life of the contract.[74]

LOSSES. The allocation of losses to the proper taxable period is discussed in another chapter.[75]

Changing Basis for Computation of Net Income. If a taxpayer should change the method of accounting employed in keeping his books for the taxable year 1919 or thereafter, he must before computing his income upon such new basis for purposes of taxation secure the consent of the Commissioner. Application for permission to change the basis of the return must be made at least thirty days in advance of the date of filing return and must be accompanied by statement specifying the class of items differently treated under the two systems and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change.[76]

Doctrine of Election. Where the taxpayer has the choice of using two or more methods of accounting, each of such methods being permissible as an approved accounting practice, and adopts one of these methods, he is held to have exercised his option and he may not change his method, particularly where it may have a material effect on his income for the year and distort his income as between different years. Thus, a wholesale liquor dealer who, for years prior to 1918, exercised the option of including excise taxes in cost of merchandise in calculating inventory, may not amend such inventory and treat such taxes as business expenses for 1918.[77]

Accounting Period: Fiscal Year. The return of a taxpayer is made and his income computed for his taxable year as a time unit, which means his fiscal year, or the calendar year if he has not established a fiscal year.[78] The term fiscal year means an accounting period of twelve months ending on the last day of any month other than December.[79] No fiscal year will, however, be

[74] O. D. 971, T. B. 28-21-1723.

[75] See Chapter 25. See paragraph above "Reserves to meet liabilities".

[76] Revenue Act of 1921, § 212; Revenue Act of 1918, § 212; Reg. 45, Art. 23, as amended by T. D. 2873; O. D. 1113, T. B. 48-21-1921.

[77] A. R. M. 121, T. B. 16-21-1574. This doctrine of election applies also in regard to *periods* of accounting. See p. 818. It is applied in regard to the excess-profits tax (See Reg. 45, Art. 843).

[78] Reg. 45, Art. 25. The taxable year 1921 is the calendar year 1921 or any fiscal year ending during the calendar year 1921.

[79] Revenue Act of 1921, § 200; Revenue Act of 1918, § 200. A return received for a period ending on any date other than the last day of some

recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith.[80] A taxpayer having an existing accounting period which is a fiscal year within the meaning of the statute not only needs no permission to make his return on the basis of such a taxable year, but is required to do so, regardless of the former basis of rendering returns. A person having no such fiscal year must make return on the basis of the calendar year. Except in the cases of a return for the taxable year 1918 and of a first return for income tax, a taxpayer makes his return on the basis (fiscal or calendar year) upon which he made his return for the taxable year immediately preceding unless, with the approval of the Commissioner, he has changed the basis of computing his net income.[81] The taxable year of a taxpayer is either a fiscal year or the calendar year, and all his income must be reported upon the basis of the taxable year. Unless an individual maintains personal books of account in which his income from business and all other sources is reflected on the basis of a fiscal year, he does not have a fiscal year which can be recognized as the basis upon which his returns may be made.[82] Where a corporation's by-laws are silent as to its fiscal year and it has for a number of years closed its books twice each year, once on December 31, but has not "ruled down" its books on that date as on August 31, returns filed on the basis of the calendar year have been held proper as a binding exercise of an option when they correctly reflect income, even though the collections of the corporation were substantially confined to the period extending from September to December and at the August closing of the books every customer carried by the corporation was mailed an itemized statement of every transaction during the preceding twelve months and this date was used by the corporation as one of the dates for the closing of its books, the reason being that the work of getting out statements, etc., was long and tedious and could best be handled during the summer

month will not be accepted, unless it is a "final return". (Mimeograph letter to collectors, No. 1148.)

80 Reg. 45, Art. 25.

81 Reg. 45, Art. 25; A. R. R. 391, T. B. 8-21-1458. A. R. R. 342, T. B. 50-20-1340. For the rule governing the computation of tax in the case of a taxpayer with a fiscal year beginning in 1918 and ending in 1919 see Reg. 45, Art. 1625; and in the case of a taxpayer with a fiscal year beginning in 1917 and ending in 1918 see Reg. 45, Art. 1621-4, and O. D. 71, T. B. 1-19-100.

82 O. D. 941, T. B. 23-21-1673.

months, when the corporation had disposed of its product and the office force was least busy.[83]

FIRST RETURNS. The law makes no provision for seeking the consent of the Commissioner to the recognition of a fiscal year, unless the taxpayer had previously filed returns on a calendar year basis; but implies rather that such fiscal period must be used. The Revenue Act of 1918 provided[84] that "if a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year."[85] The first return under the Revenue Act of 1918 of a taxpayer who theretofore made returns on a basis different from his accounting period would necessarily overlap his next previous return. The first taxable year of a corporation organized in 1918 which established a recognized fiscal year not ending in 1918 after its organization was its fiscal year ending in 1919.[86] A newly organized corporation might file its return on a fiscal year basis without applying for permission to do so, provided such basis was definitely established and the books kept in accordance therewith prior to the close of the first fiscal year.[87]

CHANGE IN ACCOUNTING PERIOD. If a taxpayer changes his accounting period, and not merely his taxable year to conform with his existing accounting period, he must as soon as possible give to the collector for transmission to the Commissioner written notice of such change and of his reasons therefor. The Commissioner will not approve a change of the basis of computing net income unless such notice is given at a time which is both (a) at least thirty days before the due date of the taxpayer's return on the basis of his existing taxable year and (b) at least thirty days before the due date of his separate return for the period between the close of the existing taxable year and the date designated as the close of the proposed taxable year. If the change in the basis of computing the net income of the taxpayer is approved by the Commissioner, the taxpayer will thereafter make his returns upon the basis of the new accounting period in accordance with

83 A. R. R. 501, T. B. 21-21-1646.

84 This provision is not contained in the Revenue Act of 1921. It was an unnecessary provision.

85 Revenue Act of 1918, §§ 226 and 232; Reg. 45, Art. 25. The method of adjusting the tax in such case is discussed in Reg. 45, Arts. 1621-4. § 205 of the Statute is applicable; § 226 has no application.

86 S. 930, T. B. 1-19-3.

87 O. D. 404, T. B. 8-20-740.

the requirements of the statute discussed elsewhere.[88] A company which earned a large income during the fiscal year ended September 30, 1918, and suffered a net loss during the year ended September 30, 1919, will not be permitted to change its accounting period for 1918 to the calendar year basis so as to be allowed to deduct the net loss from 1918 income. The accounting period for which the tax liability had accrued and the method of accounting during that period were accomplished facts which could not thereafter be changed by the Commissioner.[89] A taxpayer having made a return upon the basis of the business year best adapted to reflect his true income should not be permitted to depart from that return year.[90] Permission will not be granted to an employee of a partnership (not a partner) receiving part of his salary in the form of a share in the profits of the partnership to make his returns upon the basis of the fiscal year of the partnership.[91] Where a taxpayer has been permitted to change his accounting period from the calendar to a fiscal year and renders a return for the period from January 1 to the end of such fiscal year, both the normal tax and the surtax will be computed as though the return were filed for a full twelve-month period after the reduction of the exemptions and credits.[92] Applications for a change in accounting period must be made by the taxpayer or his duly authorized attorney or agent.[93]

Fiscal Years 1920-1921 and 1921-1922. The provisions of the Revenue Act of 1918 and the Revenue Act of 1921 with regard to fiscal years are substantially the same.[94] The regulations issued under such corresponding provision of the 1918 Law were complicated by the fact that individuals were not permitted to make their 1917 returns on a fiscal year basis. Under the 1921 Law it is to be noted that in calculating tax for a portion of a fiscal year falling within 1921, the Revenue Act of 1921 as in force on December 31, 1921, is to be regarded; in calculating the tax for a portion of a fiscal year falling within 1922, the Revenue

88 Reg. 45, Art. 26, as amended by T. D. 3032, T. B. 26-20-1026; Sol. Op. 5, T. B. 24-20-996. "Due date" means original due date, not the date to which an extension is granted. (O. D. 205, T. B. 10-19-355.)

89 T. D. 3044, T. B. 30-20-1087; see also A. R. R. 391, T. B. 8-21-1458; A. R. R. 342, T. B. 50-20-1340.

90 T. B. R. 37, T. B. 11-19-370.

91 O. D. 696, T. B. 43-20-1257.

92 O. D. 723, T. B. 45-20-1296.

93 M. 2738, T. B. 14-21-1541.

94 Cf. Revenue Act of 1921, § 205; Revenue Act of 1918, § 205. Changes are made necessary, of course, in the case of personal service corporations by the abolition of that class of corporation as of December 31, 1921.

Act of 1921 as in effect on January 1, 1922, is to be regarded. The Revenue Act of 1916, as amended, and the Revenue Act of 1917, were different laws from the Revenue Act of 1918 and contained different provisions for 1917 and 1918 respecting gross income and deductions and credits, as well as rates; the Revenue Act of 1918 is a different law from the Revenue Act of 1921, and contains different provisions respecting gross income and deductions and credits, but the rates are the same for 1920 and 1921. On the other hand, the provisions respecting gross income and deductions and credits were the same in the Revenue Act of 1918 for 1918 and 1919, though the rates imposed for the two years were different; in the Revenue Act of 1921 the provisions respecting gross income and deductions and credits are in general the same for 1921 and 1922, but the rates imposed for the two years are different. Special complications will arise under the present law in the case of insurance companies with fiscal years other than the calendar year. The regulations issued under the 1918 Law are given in the following paragraphs; in general they should be followed under the present law. However, the rule in the case of an individual's fiscal year ending in 1921 will correspond to the regulation issued under the 1918 Law in the case of a corporation with a fiscal year ending in 1918.

Fiscal Year of Corporation Ending in 1918. The method provided for computing the tax for a fiscal year beginning in 1917 and ending in 1918 is as follows: (a) The tax attributable to the calendar year 1917 is found by computing the income of the taxpayer and the tax thereon in accordance with Title I of the Revenue Act of 1916, as amended, and Title I of the Revenue Act of 1917, as if the fiscal year was the calendar year 1917, and determining the proportion of such tax which the proportion of the fiscal year falling within the calendar year 1917 is of the full fiscal year; (b) the tax attributable to the calendar year 1918 is found by computing the income of the taxpayer and the tax thereon in accordance with the present statute, as if the fiscal year was the calendar year 1918, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full fiscal year; and (c) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1917 and the tax attributable to the calendar year 1918. If a corporation made its return for the taxable year 1917 on the calendar year basis and for the taxable year 1918 on a fiscal year basis, the tax attributable to the calendar year 1917 need not again be computed and the tax attributable to the

calendar year 1918 as above computed will be the tax of the corporation for the portion of such fiscal year falling within the calendar year 1918. A personal service corporation is not required to pay the tax attributable to the calendar year 1918, since for that year it is treated substantially like a partnership for the purposes of taxation.[95]

DEDUCTIONS AND CREDITS IN THE CASE OF CORPORATION FISCAL YEAR ENDING IN 1918. Net losses deductible from net income of the fiscal year under the Revenue Act of 1918 may be deducted in computing the tax attributable to the calendar year 1917, as well as in computing the tax attributable to the calendar year 1918. In computing the tax attributable to the calendar year 1917 the net income computed for the entire period under Title I of the Revenue Act of 1916, as amended, and Title I of the Revenue Act of 1917, may be credited with the excess-profits tax computed for the entire period under Title II of the Revenue Act of 1917. In computing the tax attributable to the calendar year 1918 the net income computed for the entire period under the present statute may be credited with the war-profits and excess-profits tax computed for the entire period under Title III of the Revenue Act of 1918 at the rates prescribed for 1918. Amounts previously paid by the taxpayer on account of the income tax for such fiscal year may be credited towards the payment of the income tax imposed for such fiscal year by the Revenue Act of 1918. Any excess will be credited or refunded to the taxpayer.[96]

FISCAL YEAR OF INDIVIDUAL ENDING IN 1918. Since under the law applicable to the calendar year 1917 individuals were not permitted to make returns on the fiscal year basis, the tax of an individual for that part of a fiscal year ending in 1918 attributable to the calendar year 1917 has already been included in the tax for such calendar year and need not ordinarily again be computed. The tax for that part of the year attributable to the calendar year 1918 is found by computing the income of the taxpayer for the taxable year and the tax thereon in accordance with the Revenue Act of 1918 as if the taxable year was the calendar year 1918, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full fiscal year.[97]

[95] Reg. 45, Art. 1622.
[96] Reg. 45, Art. 1623.
[97] Reg. 45, Art. 1624.

Fiscal Year of Corporation or Individual Ending in 1919. The method provided for computing the tax for a fiscal year beginning in 1918 and ending in 1919 is as follows: (a) The tax attributable to the calendar year 1918 is found by computing the income of the taxpayer and the tax thereon in accordance with the Revenue Act of 1918 as if the fiscal year was the calendar year 1918, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full fiscal year; (b) the tax attributable to the calendar year 1919 is found by computing the income of the taxpayer and the tax thereon in accordance with the Revenue Act of 1918 as if the fiscal year was the calendar year 1919, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full fiscal year; and (c) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1918 and the tax attributable to the calendar year 1919.[98]

Personal Service Corporations. It is expressly provided by the present law that the amount of tax to be paid by personal service corporations with fiscal years ending in 1922 shall be limited to a tax for that part of such fiscal years falling within the calendar year 1922. This provision is rendered necessary by the fact that personal service corporations were not taxable as such between January 1, 1918, and December 31, 1921.[99]

[98] Reg. 45, Art. 1625.
[99] Revenue Act of 1921, § 205 (b).

CHAPTER 34

RETURNS OF INCOME

For the purpose of assessing the tax, a return of income is required, showing specifically the items of gross income and the deductions and credits allowed by law. This chapter deals with the general provisions relating to returns of income, and does not cover the annual or special returns required with respect to withholding at the source, information at the source or other matters. For a discussion of such returns attention is directed to chapters on the respective subjects.

By Whom Filed. The 1921 Law, like the Revenue Act of 1918, requires a return of income to be filed by every individual having a net income for the taxable year of $1,000 or over, if single or if married and not living with husband or wife, or of $2,000 or over, if married and living with husband or wife.[1] In addition, the present law requires that a return shall be filed by every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income.[2] A return is required of every fiduciary [3] (with the exception of receivers appointed by authority of law in possession of part only of the property of an individual) or at least one of the joint fiduciaries for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or $2,000 or the gross income is $5,000 [4] as indicated above or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a nonresident alien.[5] Minors are expressly required to make returns. The return of an incompetent must be filed for him by his committee. A return is required from every partnership and from every corporation and personal service corporation subject to the tax regardless of whether or not they have been in receipt of any income during the taxable year.[6]

1 Revenue Act of 1921, § 223; Revenue Act of 1918, § 223.

2 Revenue Act of 1921, § (a) 3.

3 See Chapter 6 for a definition of the term "fiduciary".

4 The provision as to returns when the gross income is $5,000 was not contained in the 1918 Law.

5 Revenue Act of 1921, § 225. See Revenue Act of 1918, § 225; Reg. 45 Art. 421.

6 Revenue Act of 1921, §§ 224 and 239; Revenue Act of 1918, §§ 224 and 239.

Individual Returns. Every individual whose net income as defined in the statute is $1,000 or over for the taxable year must make a return of income unless married and living with husband or wife, in which case a return must be made if the net income is over $2,000. Every individual with a gross income for the taxable year of $5,000 or over, must make a return, regardless of the amount of his net income. Individuals having less than the above amounts of income may be required to make returns or statements sufficient to satisfy the Commissioner that they are not liable to tax.[7] The return must be for the taxable year, whether calendar or fiscal. Whether or not an individual is the head of a family or has dependents is immaterial in determining his liability to render a return.[8] Under the 1918 Law, the individual return was made on Form 1040 (revised), except that it might be on Short Form 1040a (revised) where the net income did not exceed $5,000 and the net income subject to the normal tax, that is, after applying the personal exemption and other credits, did not exceed $4,000. The forms are provided by the Commissioner and may be had from the collectors of the several districts.

HUSBAND AND WIFE. A husband and wife living together may make a single joint return, in which case the tax will be computed on the aggregate income.[9] If a husband and wife, living together, have separate estates, the income from both may be reported in one return, but under the 1918 Law the amount of income of each, and the full name and address of both, was required to be shown in such return. Ordinarily, the husband, as the head and legal representative of the household, and general custodian of its income, should make the return of the aggregate income of himself and his wife. Unless the wife files a separate return of income or joins with her husband in a return which sets forth her income separately, her husband should include in his return the income accruing to the wife from services rendered by her or the sale of products of her labor. If, however, the wife does not disclose her income to the husband, each may make a return, in which case the personal exemption may be divided between the two in such proportions as they agree upon. If a husband and wife living together have an aggregate net income of $2,000 or over, or an aggregate gross

7 Revenue Act of 1921, § 1307; Revenue Act of 1918, § 1305.

8 Revenue Act of 1921, § 223; Revenue Act of 1918, § 223; Reg. 45, Art. 401.

9 Revenue Act of 1921, § 222 (b).

income of $5,000 or over, a return or returns are required.[10] If either husband or wife separately had an income equal to or in excess of $2,000 a return was required under the 1918 Law. If the aggregate income of both was $2,000 or more, the treasury department required a return, although neither might have an income of $2,000.[11] The treasury department has ruled that a husband and wife living together may, at their option, file separate returns of income or a single joint return. If husband and wife living together file a single joint return of income, such return is treated as the return of a taxable unit and the income disclosed by the return is subject to both normal and surtax as though the return were that of a single individual. If a husband or wife has allowable deductions for any taxable year in excess of his or her gross income for such year, such excess may, if the husband and wife are living together and a single joint return of income is filed, be deducted from the net income of the other spouse for the purpose of computing both the normal and surtax.[12] It was held under the 1918 Law that when the net income of one spouse was in excess of $2,000 but the other had allowable deductions which if applied against this net income would result in making the figure representing the aggregate net income of both less than $2,000, no return need be filed.[13] A net loss of one spouse may be deducted from the income of the other.[14] Where husband and wife clearly indicate on a single return the net income of each, such a return does not necessarily constitute a joint return. It is a matter of intent. Having separated their respective incomes, in the absence of a showing to the contrary, the presumption is that they intended to file separate returns of income, but that for convenience they have used one form. In such case both the normal and surtax should be computed on the separate income of each. This presumption is, however, overcome if the tax has been computed by the taxpayer on the combined net income, in which case, even though their incomes have been separated and can be identified, the return is held to be a joint return and both the normal and surtax will be assessed on the basis of combined net income.[15] A husband and wife may elect to file a joint return one year and separate returns the next, regardless of whether such election re-

[10] Revenue Act of 1921, § 222 (b).

[11] Reg. 45, Arts. 401, 305. See Revenue Act of 1921, § 216 (c).

[12] Sol. Op. 90, T. B. 7-21-1452.

[13] O. D. 1005, T. B. 34-21-1784.

[14] Letter from treasury department dated February 3, 1921; I. T. S. 1921, ¶ 2720.

[15] O. D. 960, T. B. 26-21-1708.

sults in a benefit to them or a benefit to the government.[16] Where husband and wife have filed separate returns in the past they are not precluded from filing amended joint returns, but any claim for refund or credit arising therefrom must be filed within the period of limitation prescribed by statute.[17] Where a husband and wife file separate returns of income, one of them being filed in time and the other delinquent, such returns are not supplemental of each other and delinquency must be answered for by the one in connection with whose return it occurred.[18]

MINORS. An individual under twenty-one years of age, or under the statutory age of majority where he lives, whatever it may be, is required to render a return of income if he has a net income of his own of $1,000 or over or a gross income of $5,000 or over for the taxable year. If a minor has been emancipated by his parent, his earnings are his own income, and such earnings, regardless of amount, are not required to be included in the return of the parent. If the aggregate of the net income of a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from his earnings in case he has been emancipated, is at least $1,000, or his gross income is $5,000, a return as in the case of any other individual must be made by him, or by his guardian, or some other person charged with the care of his person or property for him. If, however, a minor has not been emancipated by his parent, who appropriates or may appropriate his earnings, such earnings, regardless of amount, are income of the parent and not of the minor for the purpose of the normal tax and surtax. In the absence of proof to the contrary, a parent will be assumed not to have emancipated his minor child and must include in his return any earnings of the minor.[19] Where a

16 O. D. 968, T. B. 27-21-1715.

17 O. D. 880, T. B. 16-21-1580.

18 Reg. 33 Rev., Art. 26.

19 Reg. 45, Arts. 403, 422 as amended by T. D. 3110, T. B. 2-21-1390.

At common law, the age at which an infant male or female reaches full majority is twenty-one years. This rule is still almost universal by statute in the case of males but in Arkansas, California, Colorado, Idaho, Illinois, Iowa, Kansas, Maryland, Minnesota, Missouri, Nebraska, Nevada, North Dakota, Ohio, Oregon, South Dakota, Vermont and Washington the age of majority as to females, at least for some purposes, has been fixed at eighteen years. Married infants, male or female, are considered adults, whatever their age, in Iowa, Texas and Louisiana. Married female infants are considered adults, whatever their age, in Maryland, Oregon and Texas, and in Alabama if over eighteen and Nebraska if over sixteen years of age. A married female infant is considered an adult in Washington, whatever her age, provided her husband has attained his legal majority. Eman-

married man has two sons aged 17 and 20, each earning over $1,000 per year and both wholly dependent upon their father who appropriates their entire earnings, merely giving them spending money and carfare to take them to and from their work, it has been held that inasmuch as both are minors and have not been emancipated, the entire amount of their earnings, together with his own income, should be reported in the father's return.[20] Where a father has made a *bona fide* and absolute gift of property to his minor child, the income therefrom need not be included in the father's return of gross income even though the father administers the property and collects the in-

cipation is not an exact term. (Dunks v. Grey, 3 Fed. 862, 865.) It is to be determined upon the peculiar facts and circumstances of each case and is never presumed (Brosius v. Barker, 154 Mo. App. 657; 136 S. W. 19). Emancipation is the relinquishment by the parent of control and authority over his child, conferring on the child the right to his earnings and extinguishing the parents' legal duty of support. (Rounds Bros. v. McDaniel, 133 Ky. 669; 118 S. W. 956, 958.) Emancipation may be complete or incomplete. Complete emancipation is an entire surrender of all the rights to the care, custody and earnings of the child, as well as a renunciation of parental duties, and the test to be applied is the preservation or destruction of the parental and filial relationship. (Brosius v. Barker, Supra.) Emancipation may also be express or implied: It is express when the parent voluntarily agrees with the child, who is able to take care of and provide for himself, that he may go from home, earn his own living, and control his earnings, or when the father voluntarily transfers the custody and keeping of the child to another. An express emancipation cannot be renounced by the parent. An implied emancipation results where the parent by his acts or conduct, impliedly consents that the minor may leave home and shift for himself; the father, under these circumstances, however, being authorized to renounce the same within a reasonable time. (Rounds Bros. v. McDaniel, Supra.) Living separately from the family does not necessarily establish a child's emancipation. (Sherburne v. Hartland, 37 Vt. 528.) The better rule is that an infant husband is entitled to his own wages so far as they are necessary to the support of his wife and children, even though he married without the consent of his father. (Commonwealth v. Graham, 157 Mass. 73; See also: Bristor v. Chicago & N. W. Ry. Co., 128 Iowa, 479, 104 N. W. 487; Alexandria v. Bethlehem, 16 N. J. L. 119; In re. Dunavant, 96 Fed. 542.) Although under the common law a father is entitled to the services of his unemancipated minor children (The Hattie Law, 14 Fed. 880) and to money paid them for such services by others (Allen v. Allen, 60 Mich. 635, 27 N. W. 702), he is not entitled to his children's income from separate estates (Wheeler v. St. Joseph, 31 Kans. 640, 3 Pac. 297; Hillebrant v. Brewer, 6 Tex. 45; Grangiac v. Arden, 10 Johns. (N. Y.) 293; Boobier v. Boobier, 39 Maine 406; Mears v. Bickford, 55 Maine 528). When a father receives income from his children's separate estates he must account therefor as a trustee. See Darlington v. Turner, 202 U. S. 195.

[20] O. D. 797, T. B. 6-21-1436.

come for the child. In such a transaction there is no presumption that the gift is or is not *bona fide*, but the burden will be upon the father in each case to show that it is an absolute gift to the child.[21]

INCOMPETENTS. A fiduciary acting as the committee of an insane person having an income of $1,000 or $2,000, according to the marital status of such person, or a gross income of $5,000, must make a return for such incompetent (under the 1918 Law on Form 1040 (revised) or 1040A (revised), according to the amount of net income), and pay the tax.[22]

AGENTS. The law provides that if a taxpayer is unable to make his own return, the return shall be made by a duly authorized agent, or by the guardian or other person charged with the care of the person or property of such taxpayer.[23] If the return is made by the agent, the reason therefor must be stated.[24] If the return is made by an agent, when by reason of illness, absence or nonresidence the person liable for the return is unable to make it, the agent assumes the responsibility for making the return and incurs liability to the specific penalties provided for erroneous, false or fraudulent returns.[25] There may be a fiduciary relationship between an agent and the principal, but the word "agent" does not denote a "fiduciary" for purposes of the income tax.[26] Unless otherwise provided, therefore, the principal and not the agent is subject to the liability under the law.[27] Notice of failure to make return may be served upon an agent. Upon such notice the agent will be permitted to file evidence with the collector showing that the individual for whom he acts did not receive taxable income during the year, or that the agent filed the return with some other collector, as provided by law.[28]

Corporation, Fiduciary and Partnership Returns. The subject of returns by corporations, including new provisions regarding consolidated returns by affiliated corporations and the subject of returns by partnerships and fiduciaries, are discussed in previous chapters.[29]

[21] Sol. Op. 14, T. B. 31-20-1100.

[22] Reg. 45, Art. 422.

[23] Revenue Act of 1921, § 223; Revenue Act of 1918, § 223.

[24] See Form 1040 (used under the 1918 Law).

[25] Reg. 45, Art. 402.

[26] Reg. 33 Rev., Art. 29.

[27] T. D. 2137.

[28] Reg. 33, Art. 18.

[29] See Chapters 10, 8 and 6.

Where Returns Are Filed. Returns of income must be delivered or mailed to the collector for the district of the legal residence or principal place of business of the person making the return. Persons having no domicile or place of business in the United States, and persons in the military or naval service of the United States, may file their returns of income with the collector at Baltimore.[30] Although the law permits the return to be filed in either one of the two districts indicated above, the treasury department desires, for administrative purposes, that the return be filed in the district in which the individual resides.[31]

When Filed. Except in the case of nonresident aliens and foreign corporations, returns of income must be made on or before the fifteenth day of March following the taxable year, except that returns on the basis of a fiscal year other than the calendar year must be made on or before the fifteenth day of the third month following the close of the fiscal year. In the case of nonresident aliens and foreign corporations, returns of income are made on or before the fifteenth day of June in the case of a calendar year or on or before the fifteenth day of the sixth month following the close of the fiscal year if the taxpayer reports on a fiscal year basis.[32] Under the 1918 Law all returns of income were made on or before the fifteenth day of the third month following the close of the taxpayer's taxable year.[33] The dates above indicated will be the primary due dates for all returns of income. Unless an extension of time is obtained, the taxpayer will be held delinquent if his return is not filed on or before the primary date and will be subject to the 25% additional tax and the penalties provided by the law.[34] The rule in regard to the time for filing returns upon the death of a taxpayer or the termination of a trust is set forth elsewhere.[35]

[30] Revenue Act of 1921, § 227; Revenue Act of 1918, § 227; Reg. 45, Art. 448.

[31] Letter from treasury department dated December 17, 1914; I. T. S. 1918, ¶ 596. The treasury department recognizes that the individual has the right to choose one of two districts, where he resides in one and does business in another, and the filing in either district will be a proper compliance with the law. For the year 1913 the treasury department requested the filing of returns in the district in which the individual's principal place of business was located. This threw an undue burden on the collectors in large cities and the subsequent ruling was made in order to remedy this condition.

[32] Revenue Act of 1918, §§ 227 and 241; Reg. 45, Art. 441.

[33] Revenue Act of 1921, §§ 227 (a) and 241.

[34] R. S. 3176, as amended by Revenue Act of 1921; T. D. 2001; Reg. 45, Art. 441.

[35] See Reg. 45, Art. 442. See Chapter 6.

Last Due Date. These words are used to designate the last day upon which a return is required to be filed in accordance with the provisions of the law, or the last day of the period covered by an extension of time granted by the collector or Commissioner.[36] When the last due date as above defined falls on a Sunday or a legal holiday, the last due date will be considered the day next following, and the return should be filed not later than such following day, or, if placed in the mails, it should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return as here indicated is required to be filed.[37]

Mailing Returns. If a return is placed in the mails in due course properly addressed and postage paid, in ample time to reach the office of the collector on or before the last due date, no penalty will attach should the return not actually be received by such officer until subsequent to that date. Where a question may be raised as to whether or not the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return.[38]

Returns When Accounting Period Changed. No return can be made for a period of more than twelve months. A separate return for a fractional part of a year is, therefore, required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income, from one taxable year to another taxable year or, under the 1918 Law, but not under the present law, wherever a taxpayer making his first return of income did so on the basis of a fiscal year.[39] If the change is from calendar year to fiscal year, a separate return must be made for the period between the close of the calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year, a separate return must be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. If the taxpayer making his first return under the 1918 Law, kept his accounts on the basis of a fiscal year, he was required to make a separate return for the period between the beginning of the calendar year in which such

36 Reg. 45, Art 447; Reg 33 Rev., Art. 218.

37 Reg. 45, Art. 447; Reg. 33 Rev., Art. 219.

38 Reg. 45, Art. 447; Reg. 33 Rev., Art. 52.

39 Revenue Act of 1921, § 226; Revenue Act of 1918, § 226; Reg. 45, Art. 431.

fiscal year ended and the end of such fiscal year.[40] This requirement is omitted from the 1921 Law and it would now seem that a taxpayer with a fiscal year, and making his first return, should file such return for his full fiscal year. It is difficult to see why the 1918 Law required a return for a part of a year in such cases. An alien who arrived in the United States on September 1, 1919, and who actually kept his books of account on a fiscal year basis ending August 31, was required to render a return on the basis of such fiscal year. Notice that he maintains an accounting period for the fiscal year ending August 31, should be given to the collector for the district in which the alien resides.[41] The requirements with respect to the filing of a separate return and the payment of tax for a part of a year, are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time.[42] In the case of a return for a period of less than one year the net income should be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period, and the tax will be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.[43]

Extension of Time. The Revenue Act of 1921 makes provision in certain cases for an extension of time for filing returns. As indicated in the following paragraphs, such extensions may be granted by collectors or by the Commissioner.

EXTENSION OF TIME BY COLLECTOR. It is important that the taxpayer render before the return due date a return as complete and final as it is possible for him to prepare. However, in cases of sickness or absence, collectors are authorized to grant an extension of not exceeding thirty days where, in their judgment, such further time is actually required for the making of an accurate return.[44] The application for such extension must be made prior to the expiration of the period for which the extension is required. Absence or sickness of one or more officers of a corporation at the time the return is required to be filed, will not be accepted as a reasonable cause for failure to file the return within the prescribed time, unless it is satisfactorily shown that there were no other principal officers available and suffi-

[40] Revenue Act of 1918, § 226.

[41] O. D. 456, T. B. 15-20-853.

[42] Revenue Act of 1918, §§ 226 and 239; Reg. 45, Art. 431.

[43] Revenue Act of 1921, §§ 226 (c) and 239.

[44] Revised Statutes § 3176, as amended by the Revenue Act of 1921, § 1311; Reg. 45, Art. 443. The 1918 Law was similar in this respect.

ciently informed as to the affairs of the corporation to make and verify a return. Where a husband and wife file a joint return and an extension of time has been granted to either of them, the benefit of the extension inures to both and it will be unnecessary for the other party to secure additional authority.[45] As a condition of granting an extension of time for filing a return the collector may require the submission of a tentative return and estimate of the tax (under the 1918 Law on Form 1040 T in the case of individuals, or on Form 1031 T in the case of corporations) and the payment of one-fourth of the estimated amount of tax.[46] Where a taxpayer has filed a tentative return and has failed to file a complete return within the period of the extension requested by him the complete return filed is subject to penalties prescribed for delinquency. Where a tentative return has been filed and no time has been fixed within which a complete return must be filed, the collector may at any time send notice to the taxpayer to file a complete return within a period of time therein specified by him, and a taxpayer who fails to comply with such request will incur the penalties prescribed by statute for delinquency in filing a return.[47] Where the time for filing a return has been extended by the Commissioner beyond the original due date, or beyond a period of extension granted by a collector, the collector is without authority to grant a further extension, regardless of whether or not a tentative return has been filed.[48]

Extension of Time by Commissioner. In addition to the limited extension of thirty days which may be granted by collectors, the Commissioner may grant a reasonable extension of time for filing returns whenever, in his judgment, good cause exists. He is required to keep a record of such extensions and the reasons therefor. Except in the case of taxpayers who are abroad, no such extension may be for more than six months.[49] If, before the end of a thirty-day extension granted by a collector, an accurate return can not be made, an appeal for a further extension must be made to the Commissioner with a full recital of the causes for the delay. The Commissioner will not grant an additional extension without a clear showing that a complete return can not be made before the end of the thirty-day period.

45 O. D. 521, T. B. 21-20-959.

46 Reg. 45, Art. 443.

47 T. D. 2935.

48 O. D. 650, T. B. 35-20-1171.

49 Revenue Act of 1921, § 227 (a). The rule was the same under the 1918 Law. See Revenue Act of 1918, § 227 (a); Reg. 45, Art. 445.

The Commissioner will grant no such extension beyond the original due date of the third installment of the tax. Either a complete or a tentative return as complete as possible and giving a ground for assessment of the tax, must be submitted on or before the due date as extended, and the tax shown to be due must be paid with the submission of the return. If a complete return can not be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted. In exceptional circumstances the taxpayer may apply originally to the Commissioner for an extension of time.[50]

EXTENSION OF TIME IN THE CASE OF PERSONS ABROAD. Because of the disturbed conditions abroad and the consequent interference with the usual channels of communication, an extension of time for filing returns of income for 1918 and subsequent years and for paying the tax was granted in the case of nonresident alien individuals and nonresident foreign corporations, or their proper representatives in the United States, and of American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States, for such period as might be necessary, not exceeding ninety days after proclamation by the President of the end of the war with Germany. The installments of tax actually due must be paid at the time of filing the return and the other installments must be paid as they fall due. In all such cases an affidavit was required to be attached to the return, stating the causes of the delay in filing it, in order that the Commissioner might determine that the failure to file the return in time was due to a reasonable cause and not to wilful neglect and that the return was filed without any unnecessary delay. If the showing justified the conclusion that the failure to file the return in time was excusable, no penalty would be imposed. This extension was granted as a matter of general expediency to all persons abroad owing income, war-profits, and excess-profits taxes to the federal government and was not granted upon the request of any particular taxpayer. Accordingly, in the case of taxpayers who took advantage of this general extension of time for the filing of returns and the payment of tax no interest will be collected from such taxpayers, but where a request was made by a taxpayer and an extension granted for other reasons by the Commissioner, interest will be collected at the rate of one half of one per centum per month from the time the tax would have been due if no extension had been granted. This extension also

[50] Reg. 45, Art. 444.

applied to domestic corporations whose records are kept and business transacted abroad.[51] Since the President, on November 14, 1921, proclaimed the war at an end, the above extension will expire on February 12, 1922.[52]

EXTENSION OF TIME TO ENEMIES. An extension of time was granted for such period as might be necessary, not exceeding ninety days after proclamation by the President of the end of the war with Germany, for filing returns of income for 1918 and subsequent years and for paying the tax by or for non-resident enemies or allies of enemies, as defined by section 2 of the Trading with the Enemy Act of October 6, 1917, not holding licenses granted under the provisions of that act. The whole tax shown to be due must be paid at the time of filing the return. This extension, however, did not authorize any delay in filing returns of information. This extension was also subject to the condition that all persons who on October 6, 1917, had, or since have had, or may hereafter have control of any money or other property for any such enemy or ally of enemy, or who, on October 6, 1917, were, or since have been, or may hereafter be indebted to any such enemy or ally of enemy, shall hold and deliver all such money and property in all respects subject to the Trading with the Enemy Act, and to the orders of the President and the Alien Property Custodian thereunder, and shall in due course file returns of income in respect of all such money and property for such period as may elapse or have elapsed prior to the actual delivery of such money and property to the Alien Property Custodian.[53] In other words, if delivery was made in November, 1917, a return should be filed for the portion of the year 1917 elapsing before such delivery, and if delivery was in March, 1918, a return should be filed for the year 1917 and also before March 1, 1919, for such portion of the year 1918 as elapsed before such delivery.[54] This extension will also expire February 12, 1922.

[51] Reg. 45, Art. 445, as amended by T. D. 2844; telegram from treasury department dated April 19, 1919; I. T. S. 1919, ¶ 3312; O. 809, T. B. 2-19-160; O. D. 443, T. B. 14-20-839. This general extension does not affect the liability to the 5% penalty of such individuals who file returns before the expiration of this extension period, if they fail to pay the tax due on such return within the prescribed time after it was filed. (O. D. 608, T. B. 30-20-1095.)

[52] See I. T. S. 1921, ¶ 3213.

[53] Reg. 45, Art. 446; T. D. 2673.

[54] Letter from treasury department dated May 3, 1918; I. T. S. 1919, ¶ 1515.

TENTATIVE RETURNS. Prior to the passage of the 1916 Law, extension of time could be granted only in case of sickness or absence, but the treasury department permitted foreign corporations and domestic corporations doing business in foreign countries who were unable to assemble their data on or before the primary due date, to file tentative returns, approximating as nearly as possible the actual business transacted during the year. Such tentative returns were accepted subject to the substitution later of true and correct returns when the necessary data to make the same had been received.[55] Under the 1916 Law the Commissioner had authority to grant unlimited extension in meritorious cases, thus making unnecessary the filing of tentative returns.[56] Under the present law the Commissioner will grant no extension beyond the original due date of the third installment of the tax. Either a complete or a tentative return as complete as possible, and giving the ground for assessment of the tax must be submitted on or before the due date as extended, and the tax shown to be due must be paid with the submission of the return. If a complete return can not be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted.[57] A collector, in granting an extension of time, may also require the submission of a tentative return and payment of one-fourth of the estimated amount of tax.[58] If a taxpayer has filed a tentative return for any taxable year or has paid any amount to a collector on the supposition that he will be liable for payment of tax, and later finds that his income was insufficient to require a return, a statement under oath to that effect should be filed in lieu of a complete return. If the taxpayer desires to file a claim for refund of the amount erroneously paid, a complete return will be required.[59]

Forms. The forms on which the returns of income are to be made are prescribed by the Commissioner, and may be had from the collectors of the several districts. The forms have been changed from time to time and those for 1918 contained much new matter. The following forms were prescribed under the 1918 Law. The forms for use by individuals were Form 1040 (revised) and Form 1040A (revised). The form prescribed for use by nonresident aliens was Form 1040 C., whether filed by the principal or by an agent on his behalf. Separate forms were

[55] T. D. 2137.
[56] T. D. 2561 and T. D. 2581.
[57] Reg. 45, Art. 443.
[58] Reg. 45, Art. 444.
[59] O. D. 347, T. B. 30-19-643.

provided for use by fiduciaries in cases where the tax was payable by the beneficiaries. In such case the form prescribed was Form 1041 (revised). A receiver in charge of the business of a partnership rendered return on Form 1065 (revised). In other cases returns by fiduciaries were made on Form 1040 (revised) except that it might be on short Form 1040A (revised), where the net income did not exceed five thousand dollars. Partnerships made their returns on Form 1065 (revised). Corporations, whether domestic or foreign, made their returns on Form 1120. Form A Revised (mining), Form N (oil and gas), and Form T (timber) were available for taxpayers engaged in the mining, oil or gas, or timber industries.[60] These forms were prescribed to facilitate the compilation and presentation of certain information required for the audit and examination of the returns of these classes of taxpayers. If, however, it was more convenient to use other methods of tabulation, the information so furnished if complete was accepted in lieu of these forms. The information called for by these forms should be filed with the returns in complete detail, either on the forms prescribed or in other suitable manner. This is necessary for the reason that depletion sustained must be taken into consideration in the computation of invested capital, regardless of whether or not a deduction for it was claimed or has been claimed for it in the past by the taxpayer. This requirement applies to individuals as well as corporate taxpayers.[61] The Revenue Act of 1921 provides for the establishment of a "Tax Simplification Board" which, among other duties, will investigate the forms used and make recommendations for their simplification.[62]

USE OF PRESCRIBED FORMS. Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. Failure on the part of any taxpayer to receive a blank form will not, however, excuse him from making a return. Taxpayers not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified and filed with the collector on or before the last due date. Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Imperfect or incorrect returns will not be accepted as meeting the requirements of the statute. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the

[60] A copy of Forms A, N and T will be found in the appendix to the 1920 edition of this book.

[61] T. D. 2849.

[62] See Revenue Act of 1921, § 1327.

deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form.[63]

Verification of Returns. All income tax returns must be verified under oath or affirmation before an officer duly authorized to administer oaths either by the laws of the United States or by the laws of the state or territory where such officer resides.[64] The affidavit may be made before the collector of the district or before any officer authorized by law to administer oaths.[65] Revenue agents, inspectors and special employes,[66] or any clerk in the office of the collector,[67] may, if commissioned as deputy collectors, take the oaths of taxpayers. If a return is executed before a notary in a state where the law does not require the notary to use a seal, and none is used, a certificate of a clerk of court or other officer possessing a seal, showing that the notary is duly commissioned and authorized to administer oaths, should be filed with the Commissioner; otherwise the return will not be accepted,[68] unless, as may be done, the collector waives this requirement in states where jurats are accepted in the state courts either with or without a seal, and without a certificate showing authority.[69] Every collector, deputy collector, internal revenue agent and internal revenue officer assigned to duty under an internal revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal revenue laws with which he is charged, or where such oaths and evidence are authorized by law or by regulation authorized by law to be taken. Forms are properly executed, therefore, when sworn to and subscribed before a deputy collector instead of a notary public.[70] The words "before an officer duly authorized to administer oaths either by the laws of the United States or by the laws of the State," with respect to the verification of returns, signify an officer duly authorized to administer oaths gen-

63 Reg. 45, Art. 407.

64 Reg. 45, Art. 406, as amended by T. D. 2951. Under this regulation a commissioner of deeds is authorized to administer an oath to an income tax return. T. D. 2952; See U. S. v. Benowitz, 262 Fed. 223.

65 Reg. 33, Art. 22.

66 T. D. 2235, T. D. 2238.

67 T. D. 2293.

68 T. D. 2090.

69 T. D. 2174.

70 R. S., § 3165, as amended by Revenue Act of 1918, § 1317, and by the Revenue Act of 1921, § 1311; O. D. 761, T. B. 52-20-1368.

erally, rather than an officer authorized to administer oaths only under special circumstances. Postmasters, therefore, while admittedly "duly authorized to administer oaths * * * by the laws of the United States" in a limited field, have no authority to administer oaths in general, and, possessing no specific authority for that purpose, can not properly administer oaths to taxpayers when filing returns of income.[71]

VERIFICATION ABROAD. An individual residing abroad may acknowledge his return before any duly appointed officer of the country in which he resides, authorized to administer oaths and use an official seal.[72] Where a foreign notary or other official having no seal acts as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer. Income tax returns executed abroad may be attested free of charge before United States consular officers.[73] American citizens in China executing their income tax returns may, when the services of a notary are not available, attach to their returns Consular Form 180, properly adapted, and made a part of their tax returns.[74]

VERIFICATION IN ARMY AND NAVY. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those services.[75]

Assistance by Collectors. Any assistance or information which may be needed in connection with the preparing and filing of income tax returns, is required to be furnished by the collector upon request. Questions regarding the tax will be answered upon inquiry at the internal revenue offices. When questions are directed to the treasury department at Washington asking for information which should be supplied by collectors, the letters are referred to the collectors for reply and the writers are advised accordingly.[76]

Return Made by Collector. The Revenue Act of 1921 provides that if any taxpayer fails to make and file a return or list at the time prescribed by law or by regulation made under authority of the law, or makes, wilfully or otherwise, a false or fraudulent return or list, the collector or deputy collector must make the re-

[71] O. D. 701, T. B. 43-20-1263.

[72] T. D. 2090.

[73] Reg. 45, Art. 406.

[74] O. D. 189, T. B. 8-19-327.

[75] Reg. 45, Art. 406; T. D. 2534.

[76] T. D. 1949; T. D. 1956.

turn or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, will be *prima facie* good and sufficient for all legal purposes.[77]

Erroneous Returns. Under previous laws, if a return was improperly prepared, it was returned by the collector to the taxpayer for correction, and the corrected return was accepted without penalty, provided the incorrect return showing the date of its receipt accompanied the corrected return.[78] The latest ruling under the present law, states than an imperfect or incorrect return will not be accepted as meeting the requirements of the statute.[79]

Understatement in Returns. The Revenue Act of 1921 provides that if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he is required to give due notice to the taxpayer making the return to show cause why the amount shown by the return should not be increased and upon proof that the amount was understated, he may increase the same accordingly. Such taxpayers may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector, may appeal to the Commissioner for his decision under such rules of procedure as may be prescribed by the Commissioner with the approval of the secretary. If a collector suspects that the amount of any income is understated in a return, he may on his own initiative take up the matter with the taxpayer and upon being satisfied that the amount was understated, may increase it accordingly, subject to the right of the taxpayer to appeal to the Commissioner. The Commissioner, however, without the intervention of the collector, may exercise original jurisdiction in cases of understatements of other errors in returns.[80]

[77] R. S. 3176, as amended by Revenue Act of 1921, § 1311. The Revenue Act of 1918 contained the same provision. See R. S. § 3176 as amended by § 1317 of Revenue Act of 1918.

[78] Mimeograph letter to Collectors dated February 9, 1915; I. T. S. 1919, ¶ 1541.

[79] Reg. 45, Art. 407.

[80] Revenue Acts of 1918 and 1921, § 228; Reg. 45, Art. 451.

Amended Returns. Where upon an audit of a return of an individual, a fiduciary, or a withholding agent, or as a result of an investigation made by a revenue agent, an additional tax is assessed, it is not necessary to file an amended return. Notice of the additional assessment will be given to the taxpayer by letter from the Treasury Department.[81] If a taxpayer discovers or detects expenses or liabilities which were due and payable during a preceding year, it is permissible for him to make an amended return for the year to which such expense or liability applies, include such expense in the deductions of that year, and file a claim for refund for any taxes overpaid by reason of the failure to deduct such expenses or liabilities in the original return of that year.[82] Where a corporation is called upon by a revenue inspector to make amended returns, the officers of the corporation will be given the fullest opportunity to make any investigation they may desire prior to signing such amended returns, provided, of course, such investigation does not cover an unreasonable length of time.[83]

Notice of Failure to File Returns. The Revenue Act of 1921 provides that whenever in the judgment of the Commissioner necessary, he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.[84]

81 Mimeograph letter No. 1232 to Collectors; Reg. 33 Rev., Art. 38.

82 Reg. 33 Rev., Art. 128; Reg. 45, Art. 23.

83 Letter from treasury department dated February 2, 1915; I. T. S. 1921, ¶ 2080. In 1915 and 1916 it was the practice of the treasury department to send out a letter to corporations whenever items on the return were reached, concerning which more detailed information was sought, referring to the return and briefly requesting information regarding one or more items therein. The letter ended with a statement that in the absence of an explanatory affidavit, at the end of thirty days from the date of the letter the entire amount of the deductions questioned would be suspended and an assessment returned accordingly. (I. T. S. 1917, ¶ 1623.)

84 Revenue Act of 1921, § 1307. The Revenue Act of 1918 contained the same provision. See Revenue Act of 1918, § 1305. Under the 1916 Law, when the collector possessed any information which led him to believe that any person in his district was in receipt of income for the year and did not make a return, he was required to serve a notice calling attention to the failure and to the fact that penalties for failure had been incurred. The notice also called attention to the fact that if the return was not filed within ten days from the date thereof, the books and papers of the taxpayer would be examined and a return prepared therefrom as provided by law. (Reg. 33, Art. 196.) This notice was sent out on form 1045. For the first year of the income tax, March 1 to December 31, 1913, the collector sent out an informal letter as a preliminary to the formal notice. This letter invited the taxpayer to make a return without penalty within ten days but the letter was not used in subsequent years.

Inspection of Returns by the Public. The income tax law is specific and mandatory in the matter of safeguarding from publicity the information acquired by reason of its requirements relative to annual returns of income. The law imposes on collectors, deputy collectors, agents, clerks, or other officers or employees of the bureau of internal revenue, including internal revenue agents, a penalty of fine, imprisonment, dismissal from office and forfeiture of right to hold office, for making known in any manner not provided by the law, the amount or source of income, or any particulars thereof, set forth or disclosed in a return of income by any person.[85] All internal revenue officers are cautioned to preserve as confidential all income tax returns.[86] The returns on which assessments have been made are filed in the office of the Commissioner and constitute public records and are open to inspection as such, but only upon order of the President and under rules and regulations prescribed by the secretary and approved by the President.[87] It was held that a similar provision of the 1909 Law permitting the inspection of returns was not unconstitutional.[88] The President by an executive order, dated January 7, 1920, directed that returns of income should be subject to inspection in accordance with the following regulations prescribed by the secretary of the treasury set forth in the following paragraphs.[89]

The word "return," unless otherwise indicated, includes income and profits tax and also capital stock tax returns. Written statements filed with the Commissioner designed to be supplemental to and to become a part of tax returns will be subject to the same rules and regulations as to inspection as are the returns themselves.[90] Except as hereinafter specifically indicated, the Commissioner may, in his discretion, upon written application setting forth fully the reasons for the request, grant permission for the inspection. The application will be considered by the Commissioner and a decision reached by him whether the applicant has met the conditions imposed and

[85] R. S. 3167, as amended by Revenue Act of 1921, § 1311; R. S. § 3167, as amended by the Revenue Act of 1918; Reg. 33 Rev., Art. 229; T. D. 2903, T. B. 15-19-461.

[86] T. D. 2135, T. D. 1962.

[87] Revenue Act of 1921, § 257; Revenue Act of 1918, § 257.

[88] Flint v. Stone Tracy Co., 220 U. S. 107.

[89] T. D. 2961 and 2962. See Reg. 45, Art. 1091.

[90] Reg. 45, Art. 1091. A debtor corporation may not inspect ownership certificates executed by owners of its bonds or bonds of its subsidiaries after such certificates have been forwarded to the Commissioner by the debtor corporation. (S. 1301, T. B. 6-20-434.)

whether the reasons advanced for permission to inspect are sufficient to permit the inspection. Such written application is not required of the officers and employes of the treasury department whose official duties require inspection of a return, or of the solicitor of internal revenue. When it becomes necessary for the department to furnish returns or copies thereof for use in legal proceedings, inspection of such returns or copies that necessarily results from such use is permitted. Except as indicated above, returns may be inspected only in the office of the Commissioner at Washington. A person who is permitted to inspect a return may make and take a copy thereof or a memorandum of data contained therein.[91]

RETURNS OF INDIVIDUALS. The return of an individual is open to inspection as follows: (a) By the officers and employees of the treasury department whose official duties require such inspection and by the solicitor of internal revenue; (b) by the person who made the return, or by his duly constituted attorney-in-fact; (c) by the administrator, executor or trustee of the taxpayer's estate, or by the duly constituted attorney-in-fact of such administrator, executor or trustee, where the maker of the return has died,[92] and (d) in the discretion of the Commissioner, by one of the heirs at law or next of kin of such deceased person upon showing that he has a material interest which will be affected by information contained in the return. An original letter with regard to his return written by a decedent to the collector may not be furnished to the attorneys for the estate. A certified or photostatic copy may be, however, be given to them provided the executors submit a copy of the letters testamentary issued to them by the court, together with a letter signed by them authorizing the attorneys to receive a copy of the letter in question.[93] A joint return of a husband and wife will be open to inspection (a) by the officers and employees of the treasury department whose official duties require such inspection, and by the solicitor of internal revenue, and (b) by either spouse for whom the return was made, or his or her duly constituted attorney, upon satisfactory evidence of such relationship.[94]

91 Reg. 45, Art. 1091.

92 The executor of an estate may secure copies of income tax returns filed by the decedent upon submission to the Commissioner of a certified copy of letters testamentary evidencing his appointment as executor. (O. D. 355, T. B. 31-19-654.)

93 O. D. 576, T. B. 27-20-1046.

94 Reg. 45, Art. 1091.

Returns of Partnerships. The return of a partnership will be open to inspection (a) by the officers and employees of the treasury department whose official duties require such inspection and by the solicitor of internal revenue; and (b) by any individual (or his duly constituted attorney-in-fact, or legal representative) who was a member of such partnership during any part of the time covered by the return, upon satisfactory evidence of such fact.[95]

Returns of Corporations. The return of a corporation will be open to inspection (a) by the officers and employees of the treasury department whose official duties require such inspection and by the solicitor of internal revenue; (b) upon satisfactory evidence of identity and official position, by the president, vice-president, secretary or treasurer of such corporation or if none, its principal officer; and (c) by a stockholder of record owning one per centum or more of the outstanding stock of such corporations as provided below.

A stockholder of record owning one per centum or more of the outstanding stock of a corporation may be permitted to inspect its return. Such permission will only be granted upon an application in writing to the Commissioner accompanied by an affidavit showing applicant's address, the name of the corporation, the period of time covered by the return he desires to inspect, and a certificate from the officials of the corporation or other satisfactory evidence showing the amount of the corporation's outstanding capital stock, the number of shares owned by the applicant, the date when such stock was acquired, and satisfactory proof of identity. This privilege of inspection is personal and will be granted only to the stockholder. This rule has no application to the return of a corporation filed pursuant to the Revenue Act of 1918 or the Revenue Act of 1921, specific provision, independent of Presidential regulation, being made in those acts for inspection by a stockholder of a return of a corporation filed thereunder.[96] A *bona fide* stockholder[97] of record owning one per centum or more of the outstanding stock of a corporation shall be entitled as of right, upon making request of the Commissioner, to examine the annual income

[95] Reg. 45, Art. 1091.

[96] Reg. 45, Art. 1091; Revenue Act of 1921, § 257; Revenue Act of 1918, § 257.

[97] A "stockholders protective committee," to which deposited stock has been transferred for the purpose of safeguarding the interests of the minority stockholders, is not considered a *bona fide* stockholder. (O. D. 273, T. B. 18-19-490.)

war-profits, excess-profits and capital stock tax returns of such corporation and of its subsidiaries made under the Revenue Act of 1918 or the Revenue Act of 1921. His request for permission to examine such returns must be made in writing and must be in the form of an affidavit showing his address, the name of the corporation, the period of time covered by the return he desires to inspect, the amount of the corporation's outstanding capital stock, the number of shares owned by him, the date when he acquired them and whether he has the beneficial as well as the record title to such shares. It must also show that he has not acquired his shares for the purpose of the examination of the income returns of the corporation. If he has acquired them for this purpose he is not a *bona fide* stockholder within the meaning of the statute. The application must be supported by satisfactory evidence showing that the applicant is a *bona fide* stockholder of record of the required amount of stock of the corporation. The supporting evidence may be partly in the form of a certificate signed by the president or vice-president of the corporation, and countersigned by the secretary under the corporate seal. Upon being satisfied from the evidence presented that the applicant has fully met these conditions the Commissioner will grant the permission to examine the returns and set a convenient time for the examination in the office of the Commissioner. This privilege is personal and will be granted only to the stockholder, who cannot delegate it to another.[98]

Inspection of Returns by Government Officers. When the head of an executive department (other than the treasury department) or of any other United States government establishment, desires to inspect or to have some other officer or employee of his branch of the service inspect a return in connection with some matter officially before him, the inspection may, in the discretion of the Secretary of the Treasury, be permitted upon written application to him by the head of such executive department of other government establishment. The application must be signed by such head and must show in detail why the inspection is desired, the name and address of the taxpayer who made the return, and the name and official designation of the one it is desired shall inspect the return. When the head of a bureau or office in the treasury department, not a part of the internal revenue bureau, desires to inspect

[98] Revenue Act of 1921, § 257; Revenue Act of 1918, § 257; Reg. 45, Art. 1093.

a return in connection with some matter officially before him, other than an income, profits tax or corporation excise tax matter, the inspection may, in the discretion of the secretary, be permitted upon written application to him by the head of such bureau or office showing in detail why the inspection is desired. The reasons submitted for permission to inspect as provided in this paragraph will be considered by the secretary and a decision reached by him whether the reasons are sufficient to permit the inspection.[99]

Inspection of Corporation Returns by State Officers. The proper officers of a state imposing an income tax are entitled as of right upon the request of its governor to have access to the income and profits tax returns of a corporation, association, joint-stock company or insurance company or to an abstract thereof showing its name and income. Proper officers in this connection are only those officers of the state who are charged with the enforcement of the state income tax law and who are to use the information gained by the access only in connection with such enforcement. The request or application of the governor must be in writing signed by him under the seal of his state and must show: (a) That the state imposes an income tax. (b) The name and address of the corporation, association, joint-stock company, or insurance company making the returns to which access is desired. (c) Why access is desired. (d) The names and official positions of the officers designated to have the access. (e) That such designated officers are charged with the enforcement of the state income tax law. (f) That the information to be gained by the access is to be used only in connection with such enforcement. The request or application of the governor may be addressed either to the Secretary of the Treasury or to the Commissioner but should be transmitted to the Commissioner who will set a convenient time for the access to the returns (or to an abstract thereof as he may determine). Access will be given only in the office of the Commissioner in Washington. The officers designated by the governor will not be permitted to name another person or persons to examine the returns (or abstracts) for them. The officers designated will be given access only to the returns of those corporations, associations, joint-stock companies, or insurance companies organized or doing business in their state. The officers designated may have access to lists furnished to supplement and become a part of the returns to which they are

[99] Reg. 45, Art. 1091.

given access. The proper officers, as defined above, might have access to the capital stock tax returns filed under the provisions of the Revenue Act of 1918 under the same conditions prescribed above for access to the income and profits tax returns of corporations, associations, joint-stock companies, and insurance companies. This right does not extend to the examination of capital stock tax returns filed pursuant to prior acts of Congress.[100]

Furnishing Copies of Returns. No specific provision is made in the statutes for furnishing a copy of an income return to any one. Authority to permit inspection does not carry with it authority to furnish a copy. Implied authority to furnish a copy is contained in several provisions of law constituting returns public records, and in Sections 161 and 251 R. S., which confer upon the secretary of the treasury broad power to make rules and regulations concerning "custody, use and preservation of the records, papers and property" of the department and the enforcement of the internal revenue laws. Because of the provisions contained in Section 3167 R. S., as amended by the Revenue Act of 1918 and by the Revenue Act of 1921, making it unlawful for any officer or employee of the United States "to divulge or to make known in any manner whatever not provided by law to any person * * * the amount or source of income, profits, losses, expenditures, or any particular thereof; set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law;" and also unlawful "for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return;" a copy of an income return cannot be furnished, except as provided by law, to any one except the person or persons who made the return. Furnishing the maker with a copy of his return is not a divulging of information contained therein to any person, within the meaning of Section 3167 R. S., as amended. There are numerous provisions in the statutes constituting the doing or failure to do certain things offenses against the United States, and providing for collecting unpaid taxes by suits in court and for bringing suits to recover taxes and penalties wrongfully collected. These pro-

[100] Revenue Act of 1921, § 257; Revenue Act of 1918, § 257; Reg. 45, Art. 1092.

visions would be of no avail were it held that the returns themselves, or certified copies thereof provided for in Section 882 R. S., could not be used by the government as evidence in such litigation or in preparation for same. Manifestly Congress did not, when it enacted Section 3167 R. S., intend to defeat prosecution and suits in court for which it has specifically provided. Income returns filed with the department are public records of the department, and public records in the treasury department are of right available as evidence in litigation in court unless there is some statute making it unlawful to use them as such.[101] As therefore the use of income returns or copies thereof in connection with litigation in court, where the United States government is interested in the result, is provided for by law, such returns or copies may be furnished for such use without a violation of the provisions of Section 3167 R. S., as amended.[102]

The following rules and regulations have been prescribed: The original income return of an individual, partnership, corporation, association, joint-stock company, insurance company, or fiduciary, or a copy thereof, may be furnished by the Commissioner to a United States Attorney for use as evidence before a United States grand jury or in litigation in any court, where the United States is interested in the result, or for use in the preparation for such litigation, or to an attorney connected with the department of justice designated to handle such matters upon written request of the attorney-general, the assistant to the attorney-general, or an assistant attorney-general.

When an income return or copy thereof is thus furnished, it must be limited in use to the purpose for which it is furnished and is under no condition to be made public except where publicity necessarily results from such use. In case the original return is necessary, it shall be placed in evidence by the Commissioner or by some other officer or employee of the Internal Revenue Bureau designated by the Commissioner for that purpose, and after it has been placed in evidence it shall be returned to the files in the office of the Commissioner in Washington. An original return will be furnished only in exceptional cases and then only when it is made to appear that the ends of justice may otherwise be defeated. Neither the original

[101] Winn v. Patterson, 9 Pet. 663, 677; Evanston v. Gunn, 99 U. S. 660; 17 Cyc. 306; Williams v. Conger, 125 U. S. 397, 410; Iron Silver Min. Co. v. Campbell, 135 U. S. 286, 298; Oakes v. U. S., 174 U. S. 778; Texas, etc., Ry. Co. v. Swearingen, 196 U. S. 51, 60.

[102] T. D. 2962, T. B. 4-20-711.

nor a copy of an income return desired for use in litigation in court where the United States government is not interested in the result and where such use might result in making public the information contained therein will be furnished, except as otherwise provided in the next succeeding paragraph.

A copy of an income return may be furnished by the Commissioner to the person who made the return or to his duly constituted attorney, or if the person is deceased, to his executor or administrator; or if the entity is in the hands of a receiver, trustee in bankruptcy, guardian or similar legal custodian, to the receiver, trustee or other similar custodian upon written application for same accompanied by satisfactory evidence that the applicant comes within this provision. "The person who made the return" as herein used refers in the case of an individual return to the individual whose return is desired, and in the case of a return of a corporation, association, joint-stock company, insurance company or fiduciary to the corporation, association, joint-stock company or fiduciary, a copy of whose return is desired. A corporation may also designate by proper action of its board of directors the officer or individual to whom a copy of a return made by the corporation may be furnished, and upon sufficient evidence of such action and of the identity of the officer or individual, a copy may be furnished to such person. A copy of a partnership income return will be furnished to the partners only in case all the partners join in the request therefor, it matters not what particular partner or officers of the partnership made the return. If the partnership has been dissolved the members surviving may be furnished a copy if all the members surviving join in the request.[103] Ownership certificates are filed as a result of income tax laws for the purpose of being used in connection with income tax returns and are, therefore, to be treated as returns under the regulations governing the furnishing of copies.[104]

Statistics of Income. The Commissioner will publish annually a volume of statistics of income, showing, among other things, the distribution of income between corporations and individuals and by states, by classes and by occupations.[105]

[103] Reg. 45, Art. 1091 (a), as amended by T. D. 3188, T. B. 29-21-1739.

[104] O. 879, T. B. 17-19-473.

[105] Revenue Act of 1921, § 258; Revenue Act of 1918, § 258; Reg. 45, Art. 1191.

CHAPTER 35

ASSESSMENT, PAYMENT AND COLLECTION OF THE TAX

While it follows the methods inaugurated by the Revenue Act of 1918 for the assessment, payment and collection of taxes, the Revenue Act of 1921 amends those methods in four substantial respects and in several minor details, as will be indicated in this chapter. As under the 1918 Law, it is contemplated that all assessments shall be made by the Commissioner.[1] The tax is payable in four equal installments; the first at the time fixed for filing returns, the second, third and fourth installments on the 15th days of the third, sixth and ninth months respectively following such date. This means, as it did under the 1918 Law, a taxpayer reporting on a calendar year basis (except nonresident aliens and nonresident foreign corporations) will pay the tax on or before March 15, June 15, September 15 and December 15, but as the time fixed for filing the returns of nonresident aliens and nonresident foreign corporations is changed by the present law to June 15 (or the 15th day of the sixth month following the closing of the fiscal year), such taxpayers will now pay their tax in four equal installments on June 15, September 15, December 15 and March 15 (of the second year after the year for which the tax is paid).[2] If any installment of the tax is not paid when due, the whole amount of the tax becomes payable on notice and demand by the collector. In the case of the first installment, the instructions printed on the return are deemed sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return is deemed sufficient notice of the amount due. The Revenue Act of 1921 also provides that in the case of each subsequent installment, the collector may within 30 days, and not later than 10 days, before each subsequent installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due,

[1] The 1916 Law expressly provided that all assessments should be made by the Commissioner. When an assessment was made the amount thereof was reported to the local collector, who notified the taxpayer on or before June 1 of such amount. The tax became due on the 15th of June but an additional ten-day period of grace after June 15 was allowed before the application of penalties or interest. (Revenue Act of 1916, §§ 9 (a) and 14 (a).)

[2] Revenue Act of 1921, §§ 250 (a), 241 (a) and 227 (a).

which notice shall be sufficient notice and sufficient demand.[3] The amount of any additional tax in excess of that paid is termed a "deficiency" by the Revenue Act of 1921. Any deficiency must be paid upon notice and demand by the collector, together with interest at the rate of one-half of one per cent. per month from the time the tax was due. If the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge but without intent to defraud, a five per cent. penalty is added. If the deficiency is due to fraud with intent to evade the tax, a fifty per cent. penalty is added. However, when any tax liability is discovered by the Commissioner upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or the Revenue Act of 1921, the taxpayer must be notified of such deficiency and given a period of not less than thirty days in which to file an appeal. Opportunity for a hearing is to be granted, and when any tax or deficiency is assessed after such appeal and hearing, no claim in abatement will be entertained. This provision for notice and appeal will not operate in cases in which the Commissioner believes the collection of the tax due will be jeopardized by such delay. This matter of procedure upon the finding of new or additional tax liability constitutes one of the principal changes made by the Revenue Act of 1921. The other most important changes are: (a) a provision giving the Commissioner discretion to extend the time for the payment of any deficiency (except where due to negligence or fraud) where the payment thereof would result in undue hardship to the taxpayer; (b) the provision that interest shall run with respect to additional tax from the time such tax was originally due; and (c) the provisions changing the several periods of limitation upon the assessment and collection of taxes. The new remedy provided by the Revenue Act of 1918 in the case of taxpayers designing to depart from the United States or to remove property therefrom, is amended in minor respects and is also made applicable to aliens departing from the United States whatever their design or intent. Some of the amendments indicated above are made applicable to the assessment and collection of taxes under the Revenue Act of 1917 and the Revenue Act of 1918, as will be indicated in the following paragraphs.[4]

[3] This provision substantially embodies the department's practice under the 1918 Law.

[4] Revenue Act of 1921, § 250.

Suit to Restrain Assessment or Collection. No suit for the purpose of restraining the assessment or collection of any tax may be maintained in any court.[5] The constitutionality of a law cannot be inquired into in an injunction suit against the government,[6] but may be in a stockholder's suit to enjoin a corporation from *voluntarily* paying a tax alleged to be unconstitutional.[7] An injunction will not be granted at the instance of a stockholder to restrain the officers of a corporation from paying the tax, other than voluntarily, as that would, in effect, be the same as an action to restrain the government.[8] Allegations that an assessment is irregular and void do not constitute ground for an injunction.[9] A bill in equity will not lie to enjoin collection although the tax is alleged in the bill to have been illegally assessed.[10] A collector cannot be restrained from collecting an assessment by injunction.[11] It is contrary to every principle of equity jurisprudence that the collection of taxes on personal property should be stayed by injunction.[12] The courts will not interfere by a mandamus with the executive officers of the government in the exercise of their ordinary official duties.[13] In matters which require an executive officer to exercise judgment or discretion no rule will issue for mandamus.[14] The inhibition of the Revised Statutes [15] applies to all assessments of taxes, made under color of their offices, by internal revenue officers charged with general jurisdiction of the subject of assessing the income tax. The remedy of a suit to recover back the tax after it is paid is provided by statute, and a suit to restrain its collection is forbidden. The remedy so given is exclusive,

[5] R. S. § 3224. See also § 3226, as amended by § 1318 of the Revenue Act of 1921.

[6] Delaware R. R. Co. v. Prettyman, 17 Int. Rev. Rec. 99; Allen v. Pullman's Palace Car Co., 139 U. S. 658; Dodge v. Brady, 240 U. S. 122.

[7] Pollock v. Farmers Loan & Trust Co., 157 U. S. 429; Flint v. Stone-Tracy Co., 220 U. S. 107; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Stanton v. Baltic Mining Co., 240 U. S. 103.

[8] Strauss v. Abrast Realty Co., 200 Fed. 327.

[9] Alkan v. Bean, 23 Int. Rev. Rec. 351.

[10] Snyder v. Marks, 109 U. S. 189; Dodge v. Osborn, 240 U. S. 118.

[11] State R. R. Tax cases, 92 U. S. 575; Keely v. Sanders, 99 U. S. 441.

[12] Nye v. Washburn, 125 Fed. 818.

[13] U. S. v. Black, 128 U. S. 40. The court in this case followed an earlier decision of Decatur v. Paulding (14 Pet. 497) and made clear the distinction between the mere ministerial act of the executive officer, which may be controlled by the courts by mandamus, and an act in the performance of which an officer is vested with quasi-judicial discretion.

[14] Carrick v. Lamar, 116 U. S. 423.

[15] R. S. § 3224.

and no other remedy can be substituted for it. The system of administrative measures, not judicial, to collect internal revenue taxes, with appeals to specified tribunals, and suits to recover back moneys illegally exacted is a system of corrective justice intended to be complete, and enacted under the right belonging to the Government to prescribe the conditions on which it will subject itself to the judgment of the courts in the collection of its revenues.[16] In a recent case the question arose whether or not a suit against a collector to cancel a sale to the government of the taxpayer's real estate to satisfy a tax assessed against him was prohibited and whether or not the word "restrain," as above used, should be construed in a narrow sense as prohibiting the issuance of restraining orders and injunctions or in a broad or liberal sense as applying to all suits to hinder or impede the collection of taxes. The court adopted the broader and more liberal definition.[17] The prohibition of such suits can not be waived by any officer of the government.[18] Despite this general rule receivers, as officers of the court, may, where they deem the property or income from the property in their charge not subject to the tax as contended by collecting officials, apply to the appointing court for instructions as to payment.[19] It has been held that trustees liquidating a dissolving corporation, under direction of the court as provided by the General Statutes of Connecticut[20] are not officers of such court and the court, under such circumstances, has no jurisdiction to pass on the legality of an assessment of internal revenue taxes or to issue an order restraining the assessment or collection thereof.[21]

Also despite this general rule, where the collector is acting without statutory authority and in seeking to make an unwarranted and premature distraint, his action will be enjoined as an unlawful seizure of property where irreparable injury to the assets of an estate would result, including the loss of all benefit of a period of grace of 180 days given for the payment of estate taxes.[22] It has been held in a recent case that a suit

16 Dodge v. Osborn, 240 U. S. 118.

17 Gouge v. Hart, 250 Fed. 802, appeal dismissed for want of jurisdiction, 251 U. S. 542; Reg. 45, Art. 1037.

18 Reg. 45, Art. 1037.

19 Scott v. Western Pac. R. Co., 246 Fed. 545. See also U. S. v. Nebraska Distilling Co., 80 Fed. 285.

20 §§ 3447 and 3448.

21 Willmann v. Walsh, Supreme Court of Errors of Conn., T. D. 3166, T. B. 23-21-1679.

22 Polk v. Page, U. S. Dist. Court, Dist. of Rhode Island.

may not be maintained to restrain the collection of taxes where the tax has been assessed against a corporation, which the alleged stockholders claim went out of existence many years before by virtue of the limitation in its charter limiting its corporate existence to 20 years. These stockholders claimed that the assets of the corporation had been taken over by them as partners and they had tendered a partnership return which had been refused by the collector. The contention of the partners was that the prohibition against suits to restrain the collection of taxes operates only against the party assessed, in this case, the corporation. The court, however, held that the prohibition was effective against *all* suits.[24]

Time of Payment of Tax. Except as to any taxes paid at the source, the income tax is ordinarily paid in four equal installments.[25] The first installment is paid at the time fixed by law for filing the return, the second, third and fourth installments on the 15th days of the third, sixth and ninth months respectively following such date. There are now four due dates which are, in the case of citizens and residents and resident foreign corporations:[26] March 15, June 15, September 15 and December 15 in the case of taxpayers reporting on the basis of a calendar year, and the 15th days of the third, sixth, ninth and twelfth months following the close of the fiscal year of taxpayers reporting on the basis of a fiscal year other than the calendar year.[27] The payment of the tax may be made at any time on such due dates. If payment is made by mail the remittance should be mailed in due time to reach the collector on the due date. To accommodate those who make payments after closing time a mail box is provided at the cashier's window in the office of the local collector for the deposit of such collections.[28]

[24] Markle v. Kirkendall, 267 Fed. 498.

[25] Under the 1916 Law, the Secretary, under rules and regulations prescribed by him, was required to permit taxpayers to make payments in advance in installments of an amount not in excess of the estimated taxes which would be due from them, and upon determination of the taxes actually due any amount paid in excess was refunded as taxes erroneously collected. The Secretary might allow a credit against taxes so paid in advance of an amount not exceeding the rate of 3% per annum. (Act of October 3, 1917 (Public No. 50), § 1009; T. D. 2622.)

[26] See p. 853.

[27] Revenue Act of 1921, § 250 (a); Revenue Act of 1918, § 250 (a); T. D. 3136, T. B. 11-21-1513. These provisions omit the ten-day period of grace allowed under the former law.

[28] T. D. 1728; Reg. 45, Art. 1007.

EXTENSION OF TIME FOR PAYMENTS. An unconditional extension of time for filing a return will postpone the date for payment of the first installment, but will not postpone the date of payment of the other installments unless so specified in each case.[29] In case an extension is granted on request of the taxpayer, interest at the rate of one-half of one per centum per month is added to the installment from the date it would have been due if no extension had been granted, that is, the original due date, until the installment is paid.[30]

NONRESIDENT ALIENS AND NONRESIDENT FOREIGN CORPORATIONS. The time fixed by law for the filing of returns by nonresident aliens and nonresident foreign corporations[31] reporting on the calendar year basis is now June 15th; and in the case of such taxpayers reporting on the fiscal year basis the time fixed for the filing of returns is the 15th day of the sixth month following the close of the fiscal year.[32] Therefore, nonresident aliens and nonresident (not resident) foreign corporations reporting on the calendar year basis will pay the tax in four equal installments on June 15, September 15, December 15 and March 15 (of the second year after the year for which the tax is paid). Nonresident aliens and nonresident foreign corporations reporting on a fiscal year basis will pay the tax in four equal installments on the 15th day of the sixth, ninth, twelfth and fifteenth month following the close of such fiscal year—which is at the time fixed by law for filing the return, and on the 15th day of the third, sixth, and ninth month thereafter.[33]

EFFECT OF FAILURE TO PAY INSTALLMENT. The Revenue Act of 1921, like the 1918 Law, provides that upon failure to pay an installment on time, all of the tax remaining unpaid becomes due and payable upon notice and demand.[34] It has been held that where a taxpayer pays on time only a part of an installment it is the duty of a collector within a reasonable time to demand of him the whole amount of the tax unpaid. This demand

[29] Reg. 45, Art. 1001.

[30] Revenue Act of 1921, § 250 (a); Revenue Act of 1918, § 250 (a).

[31] The term "nonresident foreign corporation", as used in this chapter, refers to foreign corporations with no office or place of business in the United States; resident foreign corporations are foreign corporations with such an office or place of business (See Revenue Act of 1918, § 241 (a)).

[32] Revenue Act of 1921, §§ 227 (a) and 241 (a).

[33] Revenue Act of 1921, § 250 (a).

[34] Revenue Act of 1921, § 250 (a); Revenue Act of 1918, § 250 (a); Reg. 45, Art. 1001.

is the culminating act which makes the installment plan of paying the tax imperative. What is a reasonable time must be determined by the facts and circumstances in each particular case.[35] Where a taxpayer filed a return of income on March 14, 1921, showing no tax due, but attached to the return a statement disclosing the fact that during the year 1920 a profit had been derived from the sale of capital assets, and immediately after the United States Supreme Court decision holding such profit to be income sent to the collector a check to be credited as the first installment of his 1920 tax with interest accrued through delay in payment, it has been ruled that the other installments may not be declared due and payable. Since his return disclosed no tax liability, it could not be held that he failed to pay an installment of tax due.[36]

Advance Payment of Tax. Income taxes may at the option of a taxpayer be paid in advance and in a single payment instead of installments, in which case the total amount must be paid on or before the time fixed by law for filing the return, or such time as extended, to wit, March 15th or the 15th day of the third month following the close of a fiscal year other than the calendar year as the case may be.[37]

Assessment of Tax. When returns made under the 1918 Law were received at the collectors' offices, they were examined and listed before being forwarded to the Commissioner. If it appeared that the tax was greater or less than shown in the return, it was recomputed. After checking the figures the Commissioner assessed the tax on the basis of the collectors' lists. The collectors then sent out bills for the taxes, either as computed by the taxpayer or as recomputed. If a taxpayer believed that he had been overassessed, he might file a claim for abatement or (after payment of the tax) for a refund of the excess. As soon as practicable the returns were carefully audited by accountants in the office of the Commissioner at Washington, assisted where necessary by reports of the examination of taxpayers' books and records made by revenue agents in the field. If error in a return was detected, the taxpayer was notified accordingly and an additional assessment was made against him or he was given the opportunity to file a claim for a refund, as the case might be.[38]

[35] Sol. Op. 77, T. B. 48-20-1326.

[36] O. D. 961, T. B. 26-21-1709.

[37] Revenue Act of 1921, § 250 (a); Revenue Act of 1918, § 250 (a); Reg. 45, Art. 1001.

[38] Reg. 45, Art. 1012.

This procedure, so far as it relates to recomputation and to amounts paid in excess of tax liability, will be retained. If, upon examination of a return by the Commissioner and recomputation of the tax and installments, the amount paid exceeds what should have been paid on the basis of the installments as recomputed, the excess so paid will be credited against subsequent installments; and if the amount already paid exceeds the correct amount of the tax such excess will be credited or refunded to the taxpayer in accordance with the rules set forth in another chapter.[39] If, however, upon such examination of a return by the Commissioner, the tax appears to be greater than that shown in the return the procedure adopted by the Revenue Act of 1921 differs materially from that provided in the 1918 Law and the practice adopted thereunder. Any such excess of the amount due upon such recomputation over the amount already paid is termed a "deficiency" by the Revenue Act of 1921. It is to be noted that interest on this deficiency is payable at the rate of one-half of one per centum. It is due on any such deficiency *from the time the tax was due*, and such deficiency must be paid upon notice and demand by the collector. Penalties are provided with regard to such deficiency and a new procedure is adopted in the Revenue Act of 1921 for the notification of the taxpayer of the amount thereof and an appeal (with hearing) by him with regard to the amount of such proposed additional tax. This subject is more fully discussed in subsequent paragraphs.[40]

Notice and Demand for Tax. The law provides[41] for five notices and demands upon the taxpayer by the collector. The *first* is a notice and demand for the whole amount of the tax unpaid, upon default in the payment of any installment. The *second* is a notice and demand for the difference between the amount of tax computed in the taxpayer's return and the amount recomputed by the Commissioner, termed "deficiency" under the present law. The *third* is a notice and demand by the collector under a return made pursuant to the revised statutes.[42] The *fourth* is a notice and demand for any tax remaining unpaid after the date when it is due, ten days after the making of which penalties and interest begin to run. The *fifth* is the notice and demand im-

[39] See Chapter 37.

[40] See p. 863.

[41] Revenue Act of 1918, § 250; Reg. 45, Arts. 1001-1012.

[42] R. S., § 3176, as amended.

puted to the taxpayer in respect of the first installment.[43] Under these provisions the treasury department sent out notice and demand (called "Satement of Tax Due") for the tax (Form 1123 taking the place of Form 1-17A) sufficiently in advance of June 15, September 15 and December 15 (or the corresponding dates in the case of taxpayers making returns on the basis of fiscal years), to give the taxpayer ten days' notice and demand *before* each of such dates. In this manner, on the 15th days of June, September and December, the tax is due and the taxpayer has had a notice and demand by the collector ten days previously. If the required installment was not paid by such dates, the penalties and interest provided by the law attached and Form 1-21A was sent out.[44] In addition, the whole amount of tax unpaid became due and payable upon a further notice and demand by the collector in accordance with the first of the above stated notices and demands. The second and third of the above stated notices and demands both referred to an amount of tax not computed by the taxpayer, but one computed by the treasury department. The second notice and demand was for a tax recomputed by the Commissioner after his examination of the return. The third notice and demand was for a tax assessed after a return made by a collector or the Commissioner in accordance with the revised statutes. Both these notices and demands were for additional taxes or for taxes computed by the treasury department in the absence of any computation by the taxpayer. In such cases, the ten-day period of grace applied, or at least no penalties attached until the additional tax had been demanded.[45] With regard to the first installment of the tax; the statute provided that the instructions printed on the return shall be deemed sufficient notice of the date when the tax is due, and sufficient demand, and the taxpayer's computation of the tax on the return shall be deemed sufficient notice of the amount due.[46] If a return was filed without payment of at

[43] See T. D. 3136, T. B. 11-21-1513. The first three notices and demands are covered respectively by subdivisions (a), (b) and (c); the fourth and fifth by subdivision (e) of § 250.

[44] T. D. 2840; M. 2784, T. B. 22-21-1666.

[45] See "Notice and Demand for Tax" (Form 1-17) and "Second Notice and Demand for Tax" (Form 1-21), used under the 1918 Law.

[46] Reading this provision in connection with the first sentence of subdivision (e) of § 250, it may be argued that on March 15th the taxpayer has had sufficient notice of the date when the tax is due (March 15th) and of the amount of tax due, and also sufficient demand; that by virtue of the first sentence of subdivision (e) the taxpayer has ten days after such demand within which to pay the tax without penalty. On the other hand,

least one-fourth of the tax shown by the return to be due, it was the practice under the 1918 Law to send a notice to the taxpayer covering the correct amount of the first installment, which carried interest from the date on which the return should have been filed up to date on which payment was made. Such taxpayer was also sent a notice and demand for the second, third and fourth installments, and an additional notice and demand if the total was not paid within ten days. Such taxpayer lost the privilege of paying the tax in installments.[47]

CHANGES MADE BY 1921 LAW. The present law provides for the notices and demands enumerated in the preceding paragraph.[48] It contains the provision for notice and demand in the case of the first installment and provides that in the case of the second, third and fourth installments the collector may, within 30 days, and not later than 10 days, before each such installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due for payment, which notice of the collector will be deemed sufficient notice and demand.[49] This provision puts the practice of the department under the 1918 Law into the statute and insures the incidence of penalties and interest from the due date of each installment. The notice and demand required for the payment of any deficiency (the second notice and demand referred to in the preceding paragraph) must, where the delay will jeopardize the collection of tax, await the determination of the hearing and appeal accorded to the taxpayer upon the determination that he owes any tax not paid or any deficiency.[50]

SERVICE OF NOTICE AND DEMAND. Notice and demand may lawfully be given by mail and when so given is presumed to have been received. The burden rests on the taxpayer to prove the

it may be argued that the words "sufficient demand" are intended as to the first installment to be paramount in effect, to the first sentence of subdivision (e); that is, that the instructions printed on the return constitute sufficient demand in the case of the first installment and that the taxpayer has not ten days after demand within which to pay the tax. The former of these interpretations would make the first due date March 25th, and the latter March 15th. The former seems to be a more reasonable interpretation of the language, and the latter to be more consistent with the statute in general.

[47] O. D. 233, T. B. 12-19-408.

[48] It also provides for a notice and demand for the payment of interest and penalties (§ 250 (b)).

[49] Revenue Act of 1921, § 250 (e).

[50] See Revenue Act of 1921, § 250 (d).

contrary in order to avoid the penalty.[51] The time within which the tax must be paid runs from the date of mailing the notice and not of its receipt by the taxpayer.[52] The practice of the department in such cases has been to permit the taxpayer to show, to the satisfaction of the Commissioner, that he did not receive the notice, and upon such showing to give the taxpayer an opportunity to pay his taxes without penalty. The record of the collector showing that notice had been duly mailed is considered merely as *prima facie* evidence that the notice was received.[53] The date appearing on the notice and demand, as the last date on which the tax may be paid without penalty, should be a date ten days subsequent to the actual mailing of the notice and not necessarily ten days from the date of the notice. The date of mailing controls.[54]

NOTICE AND DEMAND TO ABSENTEES. By reason of absence from their homes or places of business in foreign countries or in the military or other service of the country and the consequent delay in receiving mail, or by reason of the location of the residence of an individual or of the office of a corporation to which the notice was addressed at a distance from the collector's office, it is impossible for many persons to receive a notice and demand and to make payment of the tax so that such payment may be received by the collector within the ten-day period following the service of notice and demand. In all such cases it has been the practice for the collector to enter on the notice as the date on which the tax becomes due and payable a date as nearly as possible ten days after the time that the notice should be received in the ordinary course of the mails by the taxpayer. In such cases when it appears that a remittance for the tax was placed in the mails within the ten-day period after the date specified in the notice, and in cases where tardiness is occasioned because the notice was not delivered in due time by reason of delay in the mail and satisfactory evidence of that fact is furnished, the penalty and interest will not be collected.[55]

Additional Assessment Under 1918 and Prior Laws Prior to Enactment of Present Law. The 1916 Law provided[56] that "in cases of refusal or neglect to make a return and in cases of erroneous, false, or fraudulent returns, the Commissioner shall, upon

[51] U. S. v. General Inspection and Loading Co., 204 Fed. 657; Reg. 45, Art. 1007.

[52] Reg. 45, Art. 1007.

[53] I. T. S. 1917, ¶ 2268; Reg. 45, Art 1007.

[54] T. D. 1659.

[55] Reg. 45, Art. 1007.

[56] Revenue Act of 1916, §§ 9 (a), 14 (a).

the discovery thereof, at any time within three years after the return is due, or has been made, make a return upon information obtained as provided for in the law, or require the necessary corrections to be made, and in such cases the assessment made by the Commissioner thereon shall be paid by the taxpayer immediately upon notification of the amount of such assessment."[57] The same law provided:[58] "If any person * * * fails to make and file a return or list at the time prescribed by law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. Any return or list so made and subscribed by a collector or deputy collector shall be *prima facie* good and sufficient for all legal purposes. * * * The Commissioner of Internal Revenue shall assess all taxes, other than stamp taxes, as to which returns or lists are so made by a collector or deputy collector." The duplication and conflict of these provisions were removed by the Revenue Act of 1918. It was provided by that law:[59] "If any person * * * fails to make and file a return or list at the time prescribed by law or by regulations made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. *In any such case the Commissioner may from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector.* Any return or list so made and subscribed by the Commissioner or by a collector or deputy collector and approved by the Commissioner, shall be *prima facie* good and sufficient for all legal

[57] The usual ten day period of grace, however, applied to such assessments as well as to the regular assessments.

[58] R. S., § 3176, as amended by the Revenue Act of 1916. Although the Commissioner had power summarily to assess the tax upon discovery of income which had not been reported, yet if such discovery was made prior to the day on which the tax was due (June 15th or in the case of the corporations filing for their fiscal year 165 days after the closing of the fiscal year) the tax could not be summarily assessed but might be paid at any time before the regular due date with an additional period of ten days of grace. (T. D. 2003.) Where a summary assessment was made after the regular due date, the tax was due immediately upon notice and demand given by the collector. (Reg. 33, Arts. 177 and 184.)

[59] R. S., § 3176, as amended by the Revenue Act of 1918. The amendment of this section by the Revenue Act of 1921 is of no consequence.

purposes. * * * The Commissioner of Internal Revenue shall determine and assess all taxes other than stamp taxes, as to which returns or lists are so made under the provisions of this section." The Revenue Act of 1918 also provided[60] that "except in the case of false or fraudulent returns *with intent to evade the tax*, the amount of tax due under any return shall be determined and assessed by the Commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due." In addition to removing the inconsistency of the two sections providing for summary assessment, the two last quoted provisions make three changes in the law. In the first place, the rule that the limitation of time was upon the discovery of the error by the Commissioner and not upon the making of the additional assessment,[61] was changed, and the limitation fixed upon the making of the assessment.[62] In the second place, the limitation itself was extended from three to five years.[63] In the third place, the limitation which was held formerly to apply only to summary assessments[64] was now expressly made also applicable to "suits or proceedings for the collection of any tax."[65] Additional assessment might still be made where the erroneous return was due to an honest mistake, and where the mistake was not discovered until after the tax had been assessed and paid in the regular course.[66]

FIVE-YEAR LIMITATION ON SUMMARY ASSESSMENT. The 1916 Law authorized the Commissioner to make a summary assess-

[60] Revenue Act of 1918, § 250 (d).

[61] Eliot Nat. Bank v. Gill, 210 Fed. 933, affirmed 218 Fed. 600.

[62] Revenue Act of 1918, § 250 (d).

[63] Compare Revenue Act of 1918, § 250 (d) with Revenue Act of 1916 §§ 9 (a) and 14 (a).

[64] U. S. v. Minneapolis Threshing Mach. Co., 220 Fed. 1019.

[65] Revenue Act of 1918, § 250 (d). Compare this section with Revenue Act of 1916, §§ 9 (a) and 14 (a). Sol. Op. 79, T. B. 49-20-1337.

[66] Eliot National Bank v. Gill, 218 Fed. 600; Woods v. Lewellyn, 252 Fed. 106. The same words "false or fraudulent" were still used in R. S., § 3176, as amended by the Revenue Act of 1918, which were held in the above cases to include returns honestly incorrect and thus to give the Commissioner power to make summary assessments when such returns had been filed. They are still used in R. S., § 3176, as amended by the Revenue Act of 1921.

ment of the tax on undisclosed income, if the *discovery* was made within three years after the return in which such income should have been reported was due.[67] The *assessment* was not required to be made within three years, so long as the *discovery* was made within that time.[68] The three years' limitation in this provision was not a limitation upon the right of the government to sue for unpaid taxes, but was at most a limitation upon the right of the collecting officers to make assessment and enforce the payment by the summary statutory proceeding.[69] This three-year limitation was held still applicable after the enactment of the Revenue Act of 1918 to additional assessments made under the 1909, the 1913 and the 1916 Laws.[70] It might be waived by a formal statement or the filing of amended returns which were held in effect such a waiver. By the Revenue Act of 1918 the period of limitation was made five years as to taxes assessed under the Revenue Act of 1918; the limitation was upon the making of the assessment, and was applicable to the right of the government to sue as well as to make summary assessment.[71] The limitation did not

[67] Revenue Act of 1916, §§ 9 (a) and 14 (a).

[68] Eliot National Bank v. Gill, 218 Fed. 600; O. D. 234, T. B. 12-19-409; Sol. Op. 60, T. B. 36-20-1189; Sol. Op. 92, T. B. 13-21-1534; Sol. Op. 79, T. B. 49-20-1337. While the government was fully authorized under the 1916 Law to recover taxes by suit upon discovery of liability to original or additional tax after the three-year period, the treasury department preferred that the collection should be made in the ordinary statutory method, that is, as a result of a formal assessment. In order that this might be done, taxpayers were requested to make amended returns and to execute waivers of the three-year statutory limitation. In executing such waiver, the taxpayers forfeited none of their rights and assumed no liability to any penalty that might not have been enforced against them in the absence of such waiver. If the taxpayer, against whom an additional tax liability was discovered formally accepted the findings of the examining officer and agreed voluntarily to pay the tax, this amounted to a waiver and neither amended returns nor waivers were required. (Mimeograph Letter to Collectors, No. 1192.) There was apparently no objection to a taxpayer signing a waiver where additional tax liability was discovered after the expiration of the three-year period, providing he did not question the legality of the assessment. The result of signing a waiver was to compel him to pay the tax under protest and sue for its recovery, while if a waiver was not signed, the government became the plaintiff in an action to collect such tax. Where the limitation of the statute as to assessment had run and a written waiver of exemption from assessment was given by the taxpayer, the *ad valorem* penalty of 50% addition to tax, was not assessed for delinquency in filing a return. (Reg. 33 Rev., Art. 52).

[69] U. S. v. Grand Rapids & Indiana Ry. Co., 239 Fed. 153; Sol. Op. 79, T. B. 49-20-1337.

[70] This period has been extended by the present law. See p. 862.

[71] Sol. Op. 79, T. B. 49-20-1337. But there is now a limitation on the

apply, under the 1918 Law, in the case of false or fraudulent returns with intent to evade the tax.[72]

COMPUTATION OF PERIOD. In computing the five year period, March 15, the date on which the returns should have been filed, or were filed in due course, should be excluded. The more modern general rule[73] in the interpretation of statutes, where time is to be computed from a particular day, is to exclude the day thus designated and to include the last day of the specified period.[74] It has been held under the 1916 Law that an extension of time granted by the Commissioner to taxpayers for filing their income returns operates to shift the due date for filing returns to the expiration of the period of extension and the three-year limitation begins to run from the due date as thus shifted.[75]

Additional Assessments; Rules Established by Present Law. Extensive changes have been made by the Revenue Act of 1921 in the rules discussed in the foregoing paragraph. The provisions of the present law may be summarized as follows:

(1) The statute of limitations upon the making of assessments for any tax due under any return made under the 1921 Law is reduced to *four* years, the period of limitation upon suits or proceedings for the collection of taxes under the 1918 Law being kept at *five* years.

(2) The statute of limitations upon suits or proceedings for the collection of taxes due under any return made under the 1918 Law is retained at five years; and it is also extended to *all* prior income tax laws, and the 1909 Law. As to these laws prior to the 1918 Law there had formerly been no limitation upon suits.

(3) The statute of limitations of five years upon the making of assessments for any tax due under any return made under the 1918 Law, first introduced in the 1918 Law and not formerly applicable to taxes due under any return made under any other law, is made applicable to taxes due under any return filed under all income, excess-profits and war-profits tax laws, as well as the 1909 Law, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment and collection of the tax; the period of limitation upon the making of such assessments of taxes due under laws prior to the 1918 Law hav-

right to sue for taxes due under the 1916 Law, as well as the right to make assessments.

[72] Revenue Act of 1918, § 250 (d).

[73] McCullough v. Hopper, 47 N. J. L. 189.

[74] Eliot National Bank v. Gill, 218 Fed. 600; National Bank of Commerce v. Allen, 223 Fed. 472.

[75] Sol. Op. 92, T. B. 13-21-1534.

ing formerly been three years, but being applicable to the discovery of error rather than the assessment of additional tax.[76]

(4) The statutory periods upon the making of assessments do not apply in the case of (a) a false or fraudulent return with intent to evade tax, (b) the failure to file a required return, (c) where tax must be assessed on the final determination of amortization deductions, and (d) where taxes must be assessed upon a final determination of losses and other deductions tentatively allowed pending a determination of the exact amount deductible; the amount of tax or deficiency in any of these cases being assessable and collectible at any time, subject to the right of the taxpayer to a hearing and appeal.[77]

INCOME RECEIVED DURING LIFETIME OF A DECEDENT. The Revenue Act of 1921 also provides that in the case of income received during the lifetime of a decedent all taxes due thereon shall be determined and assessed within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent.[77a]

Right of Taxpayer to Appeal. The term "deficiency," as used in the present law, refers to any amount of tax found by the Commissioner to be due in excess of that paid by the taxpayer and not carried by any credits to which the taxpayer is entitled. The Revenue Act of 1921 contains an important new provision that if upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than 30 days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing will be granted and a final decision thereon must be made as quickly as practicable. Any tax or deficiency in tax then determined to be due will be

76 It is well that all statutes should run from the making of a return to the making of the assessment rather than to the *discovery* of error. The time when discovery is made is not always easy to fix, and is peculiarily within the knowledge of the party against whom the statute would run. It seems doubtful, however, whether Congress may revive the power of the Commissioner to make assessments under the 1916 Law in cases in which the discovery was not made within three years, but in which five years have not run since the making of a return. The power to impose a retroactive tax would not seem to support such a provision. However, the government still has the power to sue in such cases, and may impose a limitation of time upon that power.

77 Revenue Act of 1921, § 250 (d).

77a Id.

assessed and paid, together with the penalty and interest, if any, applicable thereto, within 10 days after notice and demand by the collector, and in such cases no claim in abatement of the amount so assessed will be entertained. This provision does not apply if the Commissioner believes that the collection of the amount due will be jeopardized by such delay and in such case he may make the assessment without giving such notice or awaiting the conclusion of such hearing.[78]

Final Determinations and Assessments. Another new provision introduced by the Revenue Act of 1921 is the provision that if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the secretary, that such determination and assessment shall be final and conclusive, and that (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.[79]

Administrative Review. It is provided by the Revenue Act of 1921 that in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal revenue laws shall not

[78] Revenue Act of 1921, § 250 (b), (d). The purpose of this provision is to prevent additional assessments made with complete knowledge of all the facts in the case, to hasten the work of audit and examination and to secure prompt departmental decisions in which all questions shall be settled at the same time. (Report of Senate Finance Committee on Internal Revenue Bill of 1921, p. 20).

[79] Revenue Act of 1921, § 1312. This provision is explained by the Senate Finance Committee (Report of Finance Committee on Internal Revenue Bill of 1921, p. 31) as follows: "Under the present method of procedure a taxpayer never knows when he is through, as a tax case may be opened at any time because of a change in ruling by the treasury department. It is believed that this provision will tend to promote expedition in the handling of tax cases and certainty in tax adjustment."

be subject to review by any other administrative officer, employee, or agent of the United States.[80]

Extension of Time for Payment of Tax. The Revenue Act of 1918 gave the Commissioner no power to extend the time for payment of any tax, even in cases where it was manifestly to the interest of the government, as well as the taxpayer, to grant such an extension. The recent period of depression has strikingly emphasized the need of such a provision, and the Revenue Act of 1921, recognizing the defect of the previous law in this respect, provides that in the case of any "deficiency" (except where the deficiency is due to negligence or to fraud with intent to evade tax) where it is shown to the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the secretary, extend the time for the payment of such deficiency or any part thereof for such period not in excess of 18 months from the passage of the Revenue Act of 1921 (November 23, 1921) as the Commissioner may determine. In such case the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted. There will be added in lieu of other interest provided by law, as a part of such deficiency, interest thereon at the rate of two-thirds of 1% per month from the time such extension is granted; except where such other interest provided by law is in excess of interest at the rate of two-thirds of 1% per month. If the deficiency or any part thereof is not paid in accordance with the terms of the extension granted, there shall be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5% of the deficiency and interest on the deficiency at the rate of 1% per month from the time it becomes payable in accordance with the terms of such extension.[81]

The extension will be granted only in case the taxpayer establishes to the satisfaction of the Commissioner that without such extension undue hardship will result to the taxpayer. The term "undue hardship" means more than an inconvenience to the taxpayer. It is defined as meaning that substantial financial loss or sacrifice will result to the taxpayer from making payment of the deficiency at the due date. This provision of the statute is ap-

[80] Revenue Act of 1921, § 1313.

[81] Revenue Act of 1921, § 250 (f) as to the acceptance of United States bonds or notes at par in connection with the above bond; see Revenue Act of 1921, § 1329.

plicable only to deficiences in taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918, or the Revenue Act of 1921, and the deficiency referred to is only such deficiency in tax as is revealed on the examination of an income or profits tax return. It has no application to deficiencies in taxes other than deficiencies in income and profits taxes under the three acts named. Any application for the extension must be made under oath on Form 1127 in accordance with instructions printed thereon and must be accompanied by evidence showing that undue hardship to the taxpayer would result if the extension were refused. The extension will not be granted on a general statement of hardship, but in each case there must be furnished a statement of the specific facts showing what, if any, financial loss or sacrifice will result if the extension is not granted. The application, with the evidence, must be filed with the collector who will at once transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner it will be examined and within thirty days either rejected or tentatively approved. The application should, wherever practicable, contain a certified statement of assets and liabilities of the taxpayer. Where the application is tentatively approved and a bond is required it must be filed with the collector within ten days after the notification by the Commissioner that a bond is required. It must be conditioned for the payment of the deficiency and applicable penalties, if any, and interest in accordance with the terms of the extension to be granted, and must be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on federal bonds and will be subject to the approval of the Commissioner.[82]

Interest on Delinquent Taxes. The Revenue Act of 1921 makes an important change in existing law with regard to interest on delinquent taxes. Under the 1918 Law interest did not usually begin to run upon an additional assessment until ten days after notice and demand for the payment thereof.[83] But under the

[82] Revenue Act of 1921, § 250 (h), T. D. 3263. Form 1127 has not yet been issued.

[83] In the latest edition of article 1001 of Regulations 45, the department asserted the right to collect interest upon additional tax even in cases in which (1) no extension of time was granted, (2) no negligence (without intent to defraud) on the part of the taxpayer was shown, and (3) when a claim for loss in inventory values was denied. This was hardly justified by the Revenue Act of 1918 which provided for the running of interest (1) where an extension was granted, (2) where there was such negligence,

present law, which terms an additional assessment a "deficiency," interest on an additional assessment runs at the rate of 6% per annum "from the time the tax was due (or, if paid on the installment basis, on the deficiency of each installment from the time the installment was due)."[84] With this exception the interest provisions of the present law and the 1918 Law are largely the same. Where the time for the payment of any installment of the tax is postponed at the request of the taxpayer, interest at the rate of 6% per annum is added from the original due date.[85] If an understatement of the tax in the return is due to the negligence "or the intentional disregard of authorized rules and regulations with knowledge thereof," of the taxpayer, but without intent to defraud, interest at the rate of 12% per annum is added to the amount of the deficiency of each installment from the time the installment was due, which interest becomes due on notice and demand.[86] If any tax remains due and unpaid for ten days after notice and demand by the collector, or in the case of the first installment as computed by the taxpayer remains due and unpaid for ten days, interest at the rate of 12% per annum is added from the due date, except that the interest on any amount which is the subject of a *bona fide* claim for abatement filed within ten days after notice and demand, where the taxpayer has not had a hearing and a decision on an appeal, is at the rate of 6% per annum, and except that no interest is added in the case of estates of insane, deceased or insolvent persons.[87] Under the 1918 Law interest was to be added in all cases in which the demand of payment was made of the taxpayer personally, although he subsequently died, or became insane or insolvent, so that collection of the tax was made from his estate in the

and (3) where such a claim was denied. Rather, the statute prescribed (at a point where such interest should have been provided for) that if an understatement "is not due to any fault of the taxpayer, there shall be no penalty". This provision is omitted from the 1921 Law, and it is clear that under that law interest runs from the original due date in all cases of additional taxes, or deficiencies.

[84] Revenue Act of 1921, § 250 (b). This provision is natural in view of the new provision of the 1921 Law that interest may be recovered from the government in certain cases. (Revenue Act of 1921, § 1324). See Chapter 37.

[85] Revenue Act of 1921, § 250 (a); Reg. 45, Art. 1003.

[86] Revenue Act of 1921, § 250 (b); Reg. 45, Art. 1003. The quoted words were added by the 1921 Law, but represent the departmental definition of "negligence" made under the 1918 Law.

[87] Revenue Act of 1921, § 250 (e); Reg. 45, Art. 1003. The provision for a hearing and appeal are discussed on page 863.

hands of his representative.[88] Under the 1918 Law permitting the deduction of losses in inventory, if such a loss or any part thereof claimed was disallowed, interest from the original due date at the rate of 12% per annum was added to the tax not abated.[89] When it was found upon filing a complete return that the first installment of tax was underestimated at the time of filing a tentative return under the 1918 Law, interest on the amount by which the tax was underestimated was collected, irrespective of amount.[90] Where interest was collectible at the rate of 1% per month from the due date, interest was collected for the fractional part of a month, where the tax is not paid within 10 days from notice and demand for payment.[91] No interest was collectible on the difference between the amount of tax paid on the basis of an original return and that shown to be due by an amended return if the understatement in the original return was not due to negligence of the taxpayer.[92] It has been ruled by the treasury department that interest collectible upon the amount of tax due and unpaid ten days after notice and demand by the collector should be computed only upon the amount of tax shown by the return to be due and not upon the tax plus the five per cent. penalty.[93] The interest provisions of the Revenue Act of 1918 did not apply to taxes for prior years.[94]

Suits for Collection of Taxes. Prior to the Revenue Act of 1918 none of the statutes of limitations, such as the limitation of three years as to summary assessments contained in the various income tax laws, was applicable to suits by the United States to recover unpaid taxes or the balance of any unpaid tax, but at most was a limitation upon the right of collecting officers to make assessments and to enforce the tax by summary statutory proceedings.[95] This rule was changed by the Revenue Act of 1918 and the statute of limitation of five years was made applicable by that law to suits, as well as assessments.[96] As to

[88] Reg. 45, Art. 1003. No reason appears for a change in this rule under the 1921 Law.

[89] Reg. 45, Art. 1003.

[90] O. D. 74, T. B. 1-19-106.

[91] O. 884, T. B. 13-19-426.

[92] O. D. 691, T. B. 42-20-1251. This rule is not changed as stated at the beginning of this paragraph.

[93] O. D. 725, T. B. 45-20-1298. The correctness of this ruling may be doubted, since the statute states that the 5% penalty "shall be added as part of the tax".

[94] O. D. 798, T. B. 6-21-1437.

[95] U. S. v. Minneapolis Threshing Machine Co., 229 Fed. 1019.

[96] Revenue Act of 1918, § 250 (d); Sol. Op. 79, T. B. 49-20-1337; O. 833, T. B. 4-19-235.

taxes which have accrued under the 1916 Law and prior laws the government, prior to the enactment of the Revenue Act of 1921, might bring suit, without limitation as to time, whether the taxes in question had been assessed or not, and whether or not they were assessable. The only qualification upon this right to resort to a plenary suit in the absence of an assessment was that the tax must be ascertainable and determinable, on evidence, by a court, and a tax of fixed percentage on a subject or object which was so definitely described in the statute that its amount or value could be so ascertained or determined, might be recovered in an action though it had never been fixed by an assessment. The action by the government to recover unpaid taxes took the form of *indebitatus assumpsit*, or a common-law action of debt,[97] and was brought in the name of the United States in the district within which the liability to the taxes was incurred or where the party from whom the taxes were due resided at the time of the commencement of the action. Interest on the taxes sued for runs from the time the taxes were due.[98] According to practice no suit for the recovery of unpaid taxes or of any fine, penalty or forfeiture was commenced until the collector had submitted to the Commissioner a full report of all material facts and circumstances in the case and received from him express authority to proceed.[99] The fact that an additional assessment of taxes due for 1915 was barred by the statute of limitations was held to have no bearing on a claim for the abatement of 1916 taxes. While the law provided that no sums may be paid from the treasury to any person indebted to the United States, this provision did not apply to the abatement of taxes erroneously assessed for any year, and the government was obliged to pursue its remedy of a suit for the recovery of any amounts due in 1915, as it was not justified in collecting taxes for 1916 which were not due for that year.[100] The five-year period of limitation upon governmental suits to recover taxes (as distinguished from assessments first imposed by the Revenue Act of 1918 only as to taxes collectible under that law, is now made applicable to the collection by suit of taxes due under all income, excess-profits, or

97 U. S. v. Nashville, etc., Ry. Co., T. D. 2697; U. S. v. Grand Rapids, etc., Ry. Co. (and cases cited) 239 Fed. 153; U. S. v. Minneapolis Threshing Mach. Co., 229 Fed. 1019; Dollar Savings Bank v. U. S., 19 Wall. 227, 86 U. S. 227; King v. U. S., 99 U. S. 229; U. S. v. Chamberlin, 219 U. S. 250; U. S. v. Little Miami Co., 1 Fed. 700.

98 U. S. v. Erie R. R., 106 U. S. 327.

99 Reg. 45, Art. 1008.

100 A. R. M. 56, T. B. 23-20-984.

war-profits tax acts, as well as the 1909 Law, which was not an income tax act, except as to suits or proceedings begun at the time of passage of the Revenue Act of 1921. This statutory period does not apply (1) in the case of a false or fraudulent return with intent to evade tax, (2) in the case of a failure to file a required return, and (3) in the case of tax due on account of amortization deducted by the taxpayer and later disallowed, and (4) in the case of tax due on the final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible.[101]

SUITS AGAINST FORMER RESIDENTS NOW ABROAD. Where a former resident of the United States now residing in British Columbia fails to file his return for 1918 and refuses to file a return upon demand of the American consul in that country, the Commissioner should make a return for him from such information as he can obtain, and if no property is found in this country which will satisfy the tax due, but a judgment for the amount of tax due could be satisfied out of property held by the taxpayer in British Columbia, recourse may be had in the courts of that country for the collection of the tax.[102]

Lien for Unpaid Taxes. If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount is a lien in favor of the United States from the time when the assessment-list was received by the collector, except when otherwise provided, until paid, with the interest, penalties, and costs that may accrue in addition thereto, upon all property and rights to property belonging to such person.[103] In any case where there has been failure to pay the tax and it has become necessary to seize and sell real estate to satisfy it a bill in equity may be filed in a district court of the United States to enforce the lien of the United States for tax upon any real estate in which the delinquent has any right, title or interest. This remedy does not supersede distraint, but is cumulative.[104]

[101] Revenue Act of 1921, § 250 (d).

[102] S. 1156, T. B. 20-19-516. It is probable that the United States would at least have to waive any penalties if it attempted to collect this tax in the courts of British Columbia, since the courts of no country execute the penal laws of another—even penalties for any violation of statutes for the protection of its revenues. It seems somewhat doubtful whether the courts of British Columbia would entertain an action for the tax itself (Wisconsin v. Pelican Ins. Co., 127 U. S. 265; King of Spain v. Oliver, 2 Wash. 429; Whart. Confl. L. Paragraph 833; Westlake Internat. L. 1st Ed. Paragraph 388; Piggott, Foreign Judg. 209, 210).

[103] R. S. § 3186.

[104] Reg. 45, Art. 1010.

NOTICE OF LIEN. The government's lien for collection of taxes is not valid as against any mortgagee, purchaser or judgment-creditor, until notice of such lien has been filed by the collector in the office of the clerk of the district court of the district within which the property subject to such lien is situated, and is not valid in a state which by appropriate legislation authorizes the filing of such notice in the office of the registrar or recorder of deeds of the counties of that state, unless the notice is filed in the office of such registrar or recorder of deeds of the county (or parish in the state of Louisiana) within which the property subject to the lien is situated.[105] Where a corporation made an assignment for the benefit of creditors and a trustee was appointed, the third and fourth installments of its income tax for 1919 not having been paid, and two years prior to the date of assignment a mortgage was executed on the corporate property, consisting solely of stock, furniture, and fixtures, it has been held that if the mortgagee acquired his lien in good faith prior to the time a lien in favor of the government was effected, the government's lien for the tax is not superior to the rights of the mortgagee. The collector should, however, file a claim with the trustee for the taxes due and the interest thereon, calling his attention to the statutory provisions,[106] which make him personally liable if he pays out trust funds before he satisfies and pays a debt due to the United States.[107] A lien for taxes is not similar

105 Act of March 4, 1913, amending R. S., § 3186. This amendment seems to have been made in response to suggestions of the American Bar Association (Part 1, Proceedings American Bar Ass'n. 106 p. 598) and of the court in U. S. v. Curry, 201 Fed. 371, in which the harshness of enforcing the lien against innocent purchasers without knowledge or notice of the lien was emphasized. (See also U. S. v. Pacific R. R., 1 Fed. 97.) The suggestion was made by Judge Rose in the Curry case in the following language: "It would seem that by a comparatively slight change of the statute law the rights of the United States could be sufficiently protected without endangering the interests of other persons. The collector of internal revenue at the time he makes a demand upon the taxpayer might be required to transmit a copy of the demand to some office in which judgments and other recognized liens upon real estate are recorded and the records of which are consequently carefully examined by conveyancers." The lien was held to be superior to that of any one acquiring any interest in the property after the date of demand and unaffected by the fact that a subsequent purchaser became such without knowledge of the lien or claim of the government in the following cases: U. S. v. Pacific R. R., 1 Fed. 97; U. S. v. Turner, 28 Fed. Cas. No. 16,548; U. S. v. Snyder, 149 U. S. 210; U. S. v. Blacklock, 208 U. S. 75.

106 R. S., § 3467.

107 O. D. 770, T. B. 1-21-1379.

to the lien of an ordinary incumbrance. It is not displaced by a sale under a pre-existing judgment or decree, unless otherwise directed by statute. It attaches to the *res* without regard to individual ownership, and when it is enforced by sale pursuant to the statute prescribing the mode of assessing and collecting taxes, the purchaser takes a valid and unimpeachable title.[108] The lien may be enforced against any transferee of real or personal property of the taxpayer (except a mortgagee, purchaser or judgment-creditor) with respect to property transferred after the lien attaches, that is, after the filing of the list with the collector, although the transferee had no notice of the lien.[109] To create a lien demand must be made for a specific amount; all steps required by law must be pursued strictly. The lien requires an assessment, a notice of the tax due, and a specific demand upon the individual taxpayer for payment.[110] The government is not compelled to resort to distraint and sale of chattels and personal effects of a taxpayer, before instituting proceedings to enforce a lien on the taxpayer's real estate and leaseholds.[111]

TIME WHEN LIEN ATTACHES. The statute expressly provides that a lien for unpaid taxes in favor of the United States shall attach from the time when the assessment-list was received by the collector, except when otherwise provided.[112] The Revenue Act of 1921 provides[113] that "all administrative special or stamp provisions of law including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act." Under the method of collection prescribed by the present law and the 1918 Law it is uncertain when the assessment-list is intended to reach the collector.[114] In the case of a corporation which has distributed its assets prior to the time when a lien would attach thereto, the government may proceed to collect the tax as a general creditor.[115]

Priority of Federal Taxes. The government has no priority in the matter of collecting taxes from a bankrupt over the

108 Osterberg v. Union Trust Co., 93 U. S. 424.

109 U. S. v. Curry, 201 Fed. 371 (and cases cited) is modified by the amendment of R. S., § 3186.

110 U. S. v. Pacific R. R., 1 Fed. 97; U. S. v. Allen, 14 Fed. 263.

111 U. S. v. Curry, 201 Fed. 371; Mansfield v. Excelsior Refining Co., 135 U. S. 326; U. S. v. Blacklock, 208 U. S. 75.

112 R. S., § 3186.

113 Revenue Act of 1921, § 1300. The Revenue Act of 1918 provided likewise (§ 1305).

114 Revenue Act of 1921, § 250; Revenue Act of 1918, § 250.

115 See Chapter 10 in which this subject is more fully discussed.

administration expenses of the bankruptcy proceedings, its priority in this respect being limited to creditors of the bankrupt.[116]

Payment of Tax Where Property Taken Over by Alien Property Custodian. Where the property of an alien enemy has been taken over by the alien property custodian and the individual has executed a return and has no funds out of which to pay the tax shown, the return should be filed with the collector, but the alien enemy in such case can not be held responsible for failure to pay his tax, which is a debt due the government along with those of other creditors in the final disposition.[117]

Taxes Collectible by Distraint. If any person liable to pay any taxes neglects or refuses to pay the same within ten days after notice and demand, the collector or his deputy collector may collect the taxes, with the 5% penalty, and interest at the rate of 1% per month, by distraint and sale of the goods, chattels or effects, including stocks, securities, and evidences of debt, of the person delinquent.[118] Certain property is exempted from distraint in the case of the head of a family.[119] Extensive provision is made in the statute for the mode of levying distraint and proceedings on distraint.[120] Collectors are enjoined against unnecessary delays in making sales and postponing sales beyond statutory periods; they are also required to make reports promptly.[121] Surplus moneys must be deposited as internal revenue collections and cannot be returned to the legal owner of the property sold.[122] The power to distrain personal property for payment of taxes is almost as old as the common law. It is also competent for Congress to apply to realty as well as personalty the power to distrain and sell when necessary to enforce the payment of the tax. It is only the further legitimate exercise of the same power for the same purpose.[123] When goods, chattels or effects sufficient to satisfy the taxes imposed upon any person are not found by the collector or deputy collector, he is authorized to collect such taxes by seizure and sale of real estate. Distraint

116 Smietanka v. Zibell, 263 Fed. 883. See also Guaranty Title & Trust Co. v. Title Guaranty & Surety Co., 224 U. S. 152.

117 O. D. 27, T. B. 1-19-78.

118 R. S., § 3187.

119 Only heads of families are entitled to this exemption. (T. D. 1499.) The state exemption laws are inapplicable to debts due the United States—U. S. v. Howell, 9 Fed. 674.

120 R. S., § 3188 et seq.

121 T. D. 623, January 23, 1903.

122 T. D. 1373.

123 Springer v. U. S., 102 U. S. 586.

may also be used against a delinquent collector.[124] Distraint warrants issued for the seizure of property to be sold to satisfy such taxes will be deemed to have been served when seizure is made of any of the property of the delinquent taxpayer subject to distraint by the officer charged with the execution of the warrant.[125]

The property of one spouse is not subject to distraint to enforce payment of an income tax obligation of the other spouse unless there has been a transfer of property from one spouse to the other after a tax has been assessed and demand made for payment thereof.[126]

ADDITION OF $5 AS PART OF TAX. The Revenue Act of 1921 omits the provision of the 1918 Law that in any case in which, in order to enforce payment of a tax it is necessary for a collector to cause a warrant of distraint to be served, there shall also be added as part of the tax the sum of $5.[127] The addition of $5 to the tax where it became necessary for a collector to cause a warrant of distraint to be served was applicable only to income, war-profits and excess-profits taxes.[128] The charge of $5 was held applicable when a warrant of distraint was served irrespective of the fact that the delinquent might be the estate of an insane, deceased, or insolvent person.[129] The charge of $5 was held collectible not upon the issuance but upon the serving of such warrant. If the warrant is placed in the hands of the taxpayer or is read to him personally, it is considered as having been served whether payment of the tax is made at once or is deferred so that it becomes necessary to seize property of the taxpayer.[130]

Procedure in Case of Taxpayers Contemplating Removal or Concealment of Property to Defeat Collection of Tax. If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be

124 Reg. 45, Art. 1009.

125 T. D. 3042, T. B. 7-21-1454.

126 O. D. 1056, T. B. 40-21-1856.

127 Revenue Act of 1918, § 250 (f).

128 T. D. 3126, T. B. 7-21-1454, modifying T. D. 3042; O. D. 304, T. B. 24-19-575; O. D. 652, T. B. 35-20-1175.

129 O. D. 270, T. B. 18-19-486.

130 O. D. 442, T. B. 14-20-837.

brought without delay, the Commissioner may declare the taxable period for such taxpayer *immediately* terminated and cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In such a case the taxpayer is entitled to a full personal exemption and credit for dependents, if otherwise allowable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this provision the finding of the Commissioner, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A person who is not in default in making returns or in paying other taxes may procure the postponement until the usual time of the payment of taxes declared or declarable to be due as above indicated by depositing with the Commissioner United States bonds of a principal amount double the estimated amount of taxes due from such person for the taxable year or by furnishing such other security as may be approved by the Commissioner. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the above finding and declaration, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him. If security is approved and accepted and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any of the above proceedings prior to the expiration of the time otherwise allowed for paying such respective taxes.[131] Under this provision it seems to be within the power of the Commissioner to declare the taxable period of a corporation terminated *immediately* upon its dissolution and to demand immediate payment of the tax for such taxable period and the tax for the preceding year or to require security for the payment thereof.[132]

131 Revenue Act of 1921, § 250 (g); Revenue Act of 1918, § 250 (g); Reg. 45, Art. 1013, as amended by T. D. 3229, T. B. 39-21-1847, amending T. D. 3216; M. 2195, T. B. 13-19-429. The difference between the present law and the 1918 Law is that under the present law the taxable period may be "immediately" terminated, while under the 1918 Law it could only be terminated at the end of the calendar month then last past.

132 See Chapter 10.

PERSONS LEAVING COUNTRY. The present law expressly provides that in the case of a citizen about to depart from the United States the Commissioner may at his discretion waive any or all of the requirements indicated in the foregoing paragraph, but that no alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws.[133] It is probable that the requirements will be waived for the present in the case of citizens. But in the case of aliens the statute requires the Commissioner to enforce the pre-existing regulations, which are indicated below.

ALIENS LEAVING COUNTRY. Aliens departing from the United States were required under the 1918 Law to present certificates of compliance with income tax obligations to internal revenue officers at the point of departure. Aliens, whether resident or nonresident, who intended to depart from this country, were required to appear before the collector or deputy collector of internal revenue for the district in which they resided and satisfy all income tax obligations with respect to income received up to and including the calendar month next preceding that of their intended departure. Upon payment of such obligations or upon satisfactory evidence that no tax was due and payable, the collector or deputy collector issued a certificate of compliance to the applicant. A certificate of compliance issued by a collector or deputy collector was required to be presented at the office of the revenue agent at the point of departure, who issued an income tax clearance which was taken up at the pier. Aliens presenting themselves at the point of departure without such certificates of compliance were examined by internal revenue officers at that point and such taxes as appeared to be due and owing were collected.[134] If any tax had been withheld from the

133 Revenue Act of 1921, § 250 (g). This provision embodies the practice of the treasury department under the 1918 Law (See Reg. 45, Art. 1013, as amended by T. D. 3229, T. B. 39-21-1847, amending T. D. 3216). Under the latest ruling under that law the Commissioner waived the requirements in the case of citizens. It is to be noted, however, that he may restore the requirement at any time in accordance with the practice in 1920 and earlier years.

134 Reg. 45, Art. 1013, as amended by T. D. 3229, T. B. 39-21-1847, amending T. D. 3216. This ruling apparently required resident aliens leaving the country temporarily to pay all income tax on all income up to the month of departure; they were formerly permitted to make provisions for the payment of installments subsequent to departure, and the filing of returns and payment of tax for the succeeding year (O. D. 331, T. B. 28-19-

wages or other income of an alien, credit therefor was given to the alien in computing any balance of tax due the United States government. An alien appearing before the collector was questioned as to his earnings for the current taxable year and prior years.[135] If the name of an alien leaving the country did not appear on any Form 1042 filed by his employer for past years, the collector might, for the purpose of determining the alien's tax liability, require the employer to furnish statements of the alien's earnings for the years in question.[136] An alien who was a resident during the past year and decided to return to his native country was classified as a nonresident alien for the taxable period of the present year.[137] For the purpose of the Revenue Act of 1918 the Virgin Islands are foreign territory and a trip to these islands was a departure from the United States. Citizens of the Virgin Islands residing in the United States and planning to go to the islands were treated in the same manner as citizens of the United States in the matter of satisfying income tax obligations before departing from this country.[138] The above rules with respect to departing aliens did not apply to representatives of foreign countries bearing diplomatic passports.[139] The servants of a diplomatic representative of a foreign country were not examined for income purposes when such servants accompanied the diplomat upon his departure from the United States.[140]

Penalty for Violation. If a taxpayer violates, or attempts to violate, the provision discussed in the foregoing paragraphs, in addition to all other penalties there will be added as part of the tax 25% of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time the tax became due.[141]

617). See also O. D. 131, T. B. 3-19-205; O. D. 840, T. B. 10-21-1501. The ruling rendered inapplicable former rulings regarding American citizens departing from this country. (See M. 2195, T. B. 13-19-429; M. 2643, T. B. 51-20-1357; O. D. 500, T. B. 19-20-923; O. D. 566, T. B. 27-20-1035. Under the present law income tax obligations up to the day of departure (not up to and including the calendar month next preceding departure) will have to be satisfied.

135 M. 2195, T. B. 28-19-618.

136 O. D. 385, T. B. 4-20-709.

137 M. 2195, T. B. 13-19-429.

138 O. D. 332, T. B. 28-19-618.

139 O. D. 271, T. B. 18-19-487.

140 O. D. 812, T. B. 7-21-1455.

141 Revenue Act of 1921, § 250 (g). This penalty provision is new.

Medium of Payment of Tax. Collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered will remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.[142] Inasmuch as this provision re-enacts in all essentials the corresponding provisions of the Revenue Act of 1918, the rulings issued under that law will undoubtedly be followed under the present law. These rulings are indicated below. The date on which the collector receives an uncertified check in payment of the tax is considered the date of payment, unless the check is returned dishonored.[143] The tax may not ordinarily be paid by a check drawn on a foreign bank in foreign funds, but it may be paid by a Canadian postal money order at par.[144] If payment is made by check the taxpayer as a precaution should draw the check for such amount as to cover any collection charges by the bank, in order that the net amount received by the government may be the full amount of tax due, that is, checks must be collectible at par, and taxpayers who are not sure that their checks will be paid at par, should write beneath the amount the words "without deduction for exchange" or the words "with exchange." A collector is not required to examine all checks to see whether or not they are collectible at par, but will stamp on the face of each

[142] Revenue Act of 1921, § 1325; Revenue Act of 1918, § 1314; Reg. 45, Arts. 1731, 1732; T. D. 2851; Act of October 3, 1917 (Public No. 50), § 1010; Act of March 2, 1911 (36 Stat. 965). Prior to 1917 the treasury department did not specifically authorize the acceptance of any form of exchange in payment of internal revenue taxes, other than currency and certified checks (T. D. 1990). There was no objection to a collector accepting at his own risk, or at the risk of the government depositary, uncertified checks or any other form of exchange, for collection only. (T. D. 2158.) Where a form of remittance not authorized by law was accepted for collection, the 5% penalty was incurred by the taxpayer, if there was delay in collection and the funds were not actually received by the collector within the time provided by law. Receipt by the government depositary, in the course of collection, was held not to be receipt by the collector, as the depositary is not an agent of the collector or of the government. (T. D. 1651.)

[143] Reg. 45, Art. 1733; T. D. 2851.

[144] O. D. 1066, T. B. 42-21-1870.

the words "this check is in payment of an obligation to the United States and must be paid at par. No protest," with his name and title. If the bank on which the check is drawn should refuse to pay it at par, it will be returned through the depositary bank and will be treated in the same manner as a bad check. If any check is returned unpaid, it will be held in suspense a few days, during which time the collector will make an effort to recover the amount from the taxpayer. If the amount is recovered, the bad check will be returned to the drawer; if it is not recovered, the collector will proceed to collect the taxes by the usual methods, as though no check had been given. All expenses incident to the attempt to collect such a check and the return of it through the depositary bank must be paid by the drawer of the check to the bank on which it is drawn, since no deduction can be made from amounts received in payment of taxes. A taxpayer who tenders a check, whether certified or uncertified, in payment for taxes is also not released from his obligation until the check has been paid.[145] Where such a check is lost in the mails, a collector is not required, as a condition precedent to the issuing of a duplicate check by the taxpayer, to furnish bond indemnifying him against possible loss in connection with the first check.[146] If one check is remitted to cover two or more persons' taxes, the remittance must be accompanied by a letter of transmittal stating (a) the name of the drawer of the check; (b) the amount of the check; (c) the amount of any cash, money order or other instrument included in the same remittance; (d) the name of each person whose tax is to be paid by the remittance; (e) the amount of the payment on account of each person; and (f) the kind of tax paid.[147] In the payment of the tax the fractional part of a cent is disregarded unless it amounts to a half cent or more, in which case the fraction is increased to one cent.[148]

PAYMENT OF TAX BY CERTIFICATES OF INDEBTEDNESS. The terms of the acceptance of certificates of indebtedness are prescribed from time to time. The amount at par of the certificates of indebtedness presented by any taxpayer in payment of taxes must not exceed the amount of the taxes to be paid by him. Collectors are not authorized, unless otherwise notified by the sec-

[145] Reg. 45, Art. 1734; T. D. 2666; T. D. 2851.

[146] O. D. 626, T. B. 32-20-1125.

[147] Reg. 45, Art. 1733; T. D. 2851.

[148] Revenue Act of 1921, § 1306; Revenue Act of 1918, § 1313; Reg. 45, Art. 1721; Reg. 33 Rev., Art. 41. The fractional part of a cent is not disregarded in the computation of taxes (T. D. 3250, T. B. 48-21-1955).

retary, to receive as payment of income or profits taxes interim receipts issued by federal reserve banks in lieu of the definite certificates of the series. For the purpose of saving taxpayers the expense of transmitting such certificates as are held in federal reserve cities to the office of the collector in whose district the taxes are payable, taxpayers desiring to pay income and profits taxes by treasury certificates of indebtedness acceptable in payment of such taxes, should communicate with the collector of the district in which the taxes are payable and request from him authority to deposit such certificates with the federal reserve bank in the city in which the certificates are held. Collectors are authorized to permit deposits of treasury certificates of indebtedness in any federal reserve bank with the distinct understanding that the federal reserve bank is to issue a certificate of deposit in the collector's name covering the amount of the certificates of indebtedness at par and to state on the face of the certificate of deposit that the amount represented thereby is in payment of income and profits taxes. The federal reserve bank should forward the original certificate of deposit to the treasurer, with its daily transcript, and transmit to the collector the duplicate and triplicate, accompanied by a statement giving the name of the taxpayer for whom the payment is made in order that the collector may make the necessary record and forward the duplicate to the office of the Commissioner.[149]

Procedure with Respect to Certificates of Indebtedness. Such certificates of indebtedness may be accepted by the collector prior to the date the tax is due and in that case should be forwarded by the collector to the federal reserve bank to be held for his account until the date the tax is due and for deposit on such date. All coupons maturing on or before the date the tax is due must be detached by the taxpayer and collected in ordinary course, but all other coupons must remain attached to the certificate and be forwarded to the federal reserve bank. Any accrued interest to the date the tax is due, not covered by coupons detached as above provided, will be remitted to the taxpayer by the federal reserve bank by check, for which purpose the collector will furnish to the bank the name and address of the taxpayer, the amount and serial numbers of the certificates presented in each case, the date of issue of the certificates, and the date the tax is due. Collectors may in no case pay interest on such certificates nor accept them for an amount other or greater than their face

[149] Reg. 45, Art. 1731, as amended and supplemented by T. D. 3115, T. B. 9-21-1490. See T. D. 3143, T. B. 13-21-1537.

value. Receipts given by collectors to taxpayers should show the amount of certificates of each series received in payment of taxes. For the purpose of saving taxpayers the expense of transmitting such certificates as are held in federal reserve cities to the office of the collector in whose district the taxes are payable, taxpayers desiring to pay taxes by acceptable certificates of indebtedness should communicate with the collector and request from him authority to deposit such certificates to his credit with the federal reserve bank in the city in which the certificates are held.[150]

To Whom Tax Should Be Paid. The importance of paying taxes by check, or of securing a proper receipt for payment from the deputy collector authorized to receive taxes, is forcibly demonstrated by a recent case in which it was held that payment of money to a deputy collector other than the one authorized to receive it is not a satisfaction of the tax liability, and does not bind the collector.[151]

Receipts for Payment of Tax. Every collector to whom any payment of any tax is made is on request required to give to the taxpayer a full written or printed receipt, stating the amount paid and the particular account for which the payment was made.[152]

Form of Receipt. The only official receipt for taxes that collectors may sign under the law is the form prescribed by the department. However, there is no objection, on the part of the department, to collectors signing commercial receipts or voucher checks, but they should in signing such receipts or vouchers write or stamp across the face thereof "not an official receipt." The official receipt must also be furnished, and an unofficial receipt is not in any manner binding on the government and will not be received by it as evidence of payment of the tax.[153] Deputy collectors must give taxpayers, at the time of the payment, a personal receipt stating that the amount of payment has been received to be forwarded to the collector.[154] In the case of pay-

150 Reg. 45, Art. 1732, as amended by T. D. 3115, T. B. 9-21-1490.

151 Hurst v. Lederer, T. D. 3221, T. B. 38-21-1835. In this case the taxpayer claimed to have paid approximately $2,000 to a deputy collector in the collector's office, but this deputy was not authorized to receive payments, and the taxpayer was obliged to pay the tax a second time.

152 Revenue Act of 1921, § 251; Revenue Act of 1918, § 251. Prior to the enactment of this section receipts were issued even when they were not requested. With regard to the penalty for the simulation of income tax receipts, see U. S. v. Pittaro, I. T. S. 1921, ¶ 2358; T. D. 2874.

153 T. D. 2226.

154 T. D. 2341.

ments by check or money order the canceled check or money order receipt is usually a sufficient receipt. In case of payments by cash the taxpayer should in every instance require receipt.[155]

TAXES WITHHELD AT THE SOURCE. Whenever any debtor pays taxes withheld at the source on account of payments made or to be made by him to separate creditors, the collector is required, on request, to give a separate receipt for the tax paid on account of each creditor so that the debtor can conveniently produce such receipts severally to his creditors in satisfaction of their respective demands up to the amounts stated in the receipts. Such receipts are sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount stated in the receipt. The creditor may, upon giving the debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting and specifying the amount of tax paid as a further satisfaction of the debt to that amount, require the surrender to him of the collector's receipt.[156]

Deposit of United States Bonds or Notes in Lieu of Surety. The Revenue Act of 1921 provides that wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking, hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds or notes of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds or notes so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds or notes in lieu of surety or sureties required by law has the same force and effect as individual or corporate sureties or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds or notes deposited, and such other United States bonds or notes as may be substituted therefor from time to time as such security, may be deposited with the treasurer of the United States, a federal reserve bank, or other depository duly designated for that purpose by the secretary, which will issue receipt therefor, describing such bonds

[155] Reg. 45, Art. 1021.

[156] Revenue Act of 1921, § 251; Revenue Act of 1918, § 251. See Chapter 40.

or notes so deposited. As soon as security for the performance of such penal bond is no longer necessary, the bonds or notes so deposited will be returned to the depositor. This provision neither affects nor impairs the priority of the claim of the United States against the bonds or notes deposited or any right or remedy granted to the United States for default upon any obligation of such penal bond; neither does it affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The secretary may prescribe rules and regulations necessary and proper for carrying this provision into effect.[157]

Recovery of Taxes Paid. Taxes erroneously paid or illegally exacted may on occasion be recovered in either of two ways: (1) from the Commissioner, and (2) by an action at law against the government or the collector who received payment thereof. Generally speaking and subject to the exceptions and definitions noted in the following paragraphs, two elements are essential to the taxpayer's right of recovery: (1) he must have protested against the assessment [158] or collection of the tax sought to be recovered, and (2) such tax must have been paid under some form and degree of duress or coercion.

RECOVERY OF TAXES FROM COMMISSIONER. The universally recognized principle that an action can not be maintained for the recovery of money paid in discharge of a tax illegally assessed, unless payment was made under protest has been held by the Commissioner and other officers of the department to be too technical and too exacting for application to the refund of taxes under Section 3220 of the Revised Statutes,[159] and it would seem that a protest is not necessary to recover taxes from the Commissioner. But such a protest is essential if suit is to be maintained against an *adverse* decision of the Commissioner.[160]

RECOVERY BY ACTION AT LAW. The two above mentioned essentials or conditions to the right to recover taxes erroneously paid or illegally exacted are ordinarily requisite when recovery

157 Revenue Act of 1921, § 1329. See also Revenue Act of 1918, § 1320.

158 It has been held that a protest against the assessment is sufficient since any protest against the collection would be unavailing. The law does not require a person to do what can be of no effect. (Adams v. U. S., 1 Ct. Cl. 306.) But see Rock Island & C. R. Co. v. U. S., 254 U. S. 141.

159 Real Est. Savings Bank v. U. S., 16 Ct. Cls. 335, Int. Rev. Rec. 154, affirmed 104 U. S. 728; Chesebrough v. U. S., 192 U. S. 253.

160 Chesebrough v. U. S., 192 U. S. 253.

is sought by means of an action at law, as contradistinguished from an application to the Commissioner for a refund. There is some irreconcilable conflict between various dicta, if not decisions, of the Supreme Court and the lower federal courts in considering the nature of and necessity for a protest and duress in regard to the recovery of internal revenue taxes, and while the scope of this book does not permit an exhaustive examination of the authorities, the subject is considered in the following paragraphs in the light of some of the leading cases.

Payment Under Protest. The ancient principle of the common law is of general application that taxes voluntarily paid can not be recovered back even if they have been illegally laid or the law under which they were laid proves to be unconstitutional. The rule is founded upon the knowledge of law imputed to all taxpayers; it is also said to be one of sound public policy and quiet and good faith, operating to free the courts from the undoing of the voluntary arrangements of parties not induced by fraud, accident or excusable negligence.[161] When a voluntary payment of taxes is spoken of, the word "voluntary" is not used in its ordinary and popular sense.[162] The purpose of paying a tax under protest is, briefly, to preserve the taxpayer's rights to recover the tax should the assessment thereof prove to be wrongful or excessive, or the law under which it was laid void and unconstitutional. Since it is usually held that the making of a protest and the existence of duress are concomitant conditions to any recovery of taxes which have been paid, the necessity for a protest will be more fully discussed in a later paragraph. It appears that a collector is not personally liable for taxes if no protest or objection is made to their collection by him.[163]

Protest at Time of Filing Return. It does not seem essential, although it may be a wise precaution, also to protest at the time of filing the return upon which the assessment is based.

Form of Protest. There is no statutory requirement that a protest against the assessment and collection of internal revenue taxes be in writing.[164] A written protest is, of course, better evi-

161 Cooley on Taxation (Third Edition) Vol. II, Ch. XXIV, p. 495.

162 In many of the cases cited hereafter in which the payment involved was held to be voluntary, the payment was most unwillingly and reluctantly made.

163 Commissioners, etc., v. Buckner, 48 Fed. 533.

164 Wright v. Blakeslee, 101 U. S. 174; Stewart v. Barnes, 153 U. S. 456; Swift v. U. S., 111 U. S. 22; Shaefer v. Ketchum, 21 Fed. Cas. No. 12,693. In this respect the rule in regard to internal revenue taxes differs from that in regard to customs in which case a protest must be in writing.

dence. A protest against paying the tax includes the penalties without specific mention of the latter.[165] In one case in which a corporation had been assessed for taxes and the same were not paid, a writ of distraint was issued by the collector, and, the corporation having been notified that the tax would be collected by levy, the deputy collector counted out and took from a representative of the company a sufficient amount to pay the tax against verbal protest at the time. A written notice of protest was then served in which the corporation denied that it was liable to the tax. The court held that the protest was sufficient.[166] Under the 1909 Law the treasury department ruled that no form of protest was prescribed, that any form of protest would be sufficient if filed before payment of the tax, and that the right of protest was not to be denied.[167]

PROTEST ALONE NOT SUFFICIENT. A protest is used to give effect to attending circumstances; it gives notice that the payment is not to be considered as admitting the right of the taxing power to make demand for or to collect the tax in question. But as appears in the next paragraph, there must usually be duress or coercion, and if payment is made under protest alone without some form or degree of compulsion, the payment may be considered voluntary notwithstanding a protest was made.[168] It has been stated:[169] "Though there is some conflict in the dicta of the Supreme Court, the true doctrine seems to be that when taxes are paid under protest or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, a sufficient foundation for such a suit to recover has been established." This statement is difficult to reconcile with the authorities cited in the next paragraph.

Duress. The general rule is that where a party pays an illegal demand, with full knowledge of all the facts rendering it illegal, without an immediate and urgent necessity therefor, to release his person or property from detention, or to prevent an im-

165 Wright v. Blakeslee, 101 U. S. 174.

166 Abrast Realty Co. v. Maxwell, 206 Fed. 333.

167 T. D. 1675.

168 Lamborn v. Comm'rs, 97 U. S. 181; Merck v. Treat, 202 Fed. 133.

169 Herold v. Kahn, 159 Fed. 608. This remark of the court seems to be mere dictum since, in the first place, the tax involved was paid under a mistake of fact and, in the second place, there was probably duress in the notice sent by the collector stating that unless the tax was paid, "it will be my duty to collect the same with a penalty * * *" (See next paragraph). The case of Beer v. Moffat, 192 Fed. 984, contains the same doctrine, but recovery was denied because there was no protest or demurrer to the legality of the tax or its payment.

mediate seizure of his person or property, such payment must be deemed voluntary, and can not be recovered back.[170] It will be noted that a voluntary payment is among other things a payment "with full knowledge of all the facts rendering it illegal." A payment made without such knowledge may under certain circumstances be recovered, but not on the theory of duress. The yielding to paramount taxing authority involved in the payment of a tax under duress or coercion is quite different from a payment made under a mistake of fact; that is, a payment made when such full knowledge is wanting. This distinction is illustrated by a case[171] in which at the time certain executors paid an internal revenue inheritance tax on a life estate under protest, they had no knowledge that the life tenant had died and that the life estate had, therefore, terminated so that it was improper to use life tables to determine the value of such life estate. When knowledge is thus spoken of, however, the reference is to knowledge of facts, and not knowledge of law, which all taxpayers are presumed to have.[172] If a payment is made under a mistake of law, no relief exists. Thus in one case an importer who formally entered goods imported from Porto Rico and purchased the required stamps without protest or objection or duress in the belief that the tax was lawfully due, although the goods were not in fact lawfully taxable, was held to have made his own interpretation of law and his payment of tax was held voluntary.[173] Thus a tax paid under a statute later declared unconstitutional can not be recovered on the theory of mistake if voluntarily paid, since the mistake is one of law.[174] It has been stated that taxes illegally assessed and paid may always be recovered back if the collector understands from the payer that the taxes are regarded as illegal and that suit will be instituted to compel the refunding of them.[175] In the case containing this doctrine the tax recovered

[170] Little v. Bowers, 134 U. S. 547; Railroad Co. v. Comm'rs, 98 U. S. 541; Lamborn v. Comm'rs, 97 U. S. 181.

[171] Kahn v. Herold, 147 Fed. 575, affirmed 159 Fed. 608.

[172] Lamborn v. Comm'rs, 97 U. S. 181.

[173] Newhall v. Jordan, 149 Fed. 586. See, however, Elliott v. Swartout, 10 Pet. 137; Bend v. Hoyt, 13 Pet. 263.

[174] Lamborn v. Comm'rs, 97 U. S. 181. In Chesebrough v. U. S., 192 U. S. 253, and U. S. v. N. Y. & Cuba Mail S. S. Co., 200 U. S. 488, the constitutionality of the acts imposing the tax was attacked, but the court (except the lower court in the Chesebrough case which was reversed) did not find it necessary to consider such constitutionality since the payments were held to be voluntary and the mistake in making payments, if any, was one of law. (See also Union Pacific Co. v. Dodge, 98 U. S. 541.)

[175] Erskine v. Van Arsdale, 15 Wall. 75. This statement was contained

was one on thimble-skeins and pipe-boxes of iron which were exempt. The tax, therefore, was paid under a mistake of law and although the facts are only briefly reported, there seems to have been an absence of such duress or coercion as to make the payment an involuntary one. The same absence of duress or coercion appears in other early cases.[176] In a suit to recover back real property taxes paid by the Union Pacific Railroad Company to Dodge County, Nebraska, it appeared that in due time the tax lists with warrants attached for their collection were delivered to the treasurer of the county. These warrants authorized the treasurer, in order to enforce collection, to seize the personal property of any persons making default in the payment of any taxes charged upon the lists. No demand for taxes was necessary, it being the duty of every person subject to taxation to attend at the treasurer's office and make payment. The company so attended and made payment filing at the same time a protest in general terms containing no specification of alleged illegality, or designation of particular property as wrongfully included in the assessment. Although the company had personal property in the county which might have been seized, no special effort had been made or active steps taken to enforce collection, and no other notice given by the taxing authorities than such as the law implied. Three years afterward a case was decided which was

in a charge of the lower court to the jury which was sustained by the Supreme Court. (See next note.)

176 Elliott v. Swartout, 10 Pet. 137; Bend v. Hoyt, 13 Pet. 263; Philadelphia v. Collector, 5 Wall. 720; Collector v. Hubbard, 12 Wall. 13. In the first two of these cases, which were customs cases, the payments were made to release goods held for duties on imports and the protest became necessary in order to show that the legality of the demand was not admitted when payment was made. The recovery rested upon the fact that the payment was made to release property from detention and the protest saved rights which grew out of that fact. The detention of property under such circumstances would seem to constitute duress. (See, however, Newhall v. Jordan, 149 Fed. 586 in which it was conceded that the importer could not have obtained possession of the goods without making the payment, recovery being still denied. See also U. S. v. N. Y. & Cuba S. S. Co., 200 U. S. 488.) In the third and fourth of these cases, which were internal revenue cases, recovery was based upon the ground that the several provisions in the acts under which the taxes were imposed warranted the conclusion as a necessary implication that Congress intended to give the taxpayer the remedy to recover, it being expressly so stated in the fourth case. The case of Erskine v. Van Arsdale, 15 Wall. 75, (see note 171) probably falls within the same class as the third and fourth cases. It is to be noted that the Court in Herold v. Kahn, 159 Fed. 608, uses Philadelphia v. Collector, 5 Wall. 720, as one of its authorities for the statement which has been criticised above. (See note 169.)

supposed to hold that the particular lands were exempt from taxation, whereupon the company brought suit to recover the taxes involved. It was held that no such immediate and urgent necessity for the payment of the taxes in controversy existed as to imply that such payment was made under compulsion.[177] In what is perhaps the leading case [178] on the subject of duress, stamps were purchased from the collector for the purpose of affixing them to a deed to a building company. The collector was not informed at the time of the purchase of this particular purpose and no intimation, written or oral, was given him of any claim by the purchaser of the stamps that the law requiring the affixing of the stamps was unconstitutional and that he was making the purchase under duress. About 19 months after the payment, an application was made to the Commissioner for a refund which was denied. It was held that no duress existed. While this case is cited as an authority for the general rule stated at the beginning of this paragraph and does not appear ever to have been questioned, its facts do not even disclose the making of a protest,[179] and the only duress claimed did not come from the government or its agent but from a third party.[180] Beyond this and in the light of its facts it is not, strictly speaking, an authority upon the question of duress and the court intimates that the rule as to duress is less rigorous on some occasions than on

177 Union Pacific Co. v. Dodge, 98 U. S. 541. The provisions of the state statute levying the tax involved in this case do not clearly appear, but it may well be that the rule as to what constitutes duress in cases of real property taxation may vary from the rule in cases arising under the internal revenue laws. For instance, the owner of real property always has his action of ejectment. To the same general effect see Simons v. U. S., 19 Ct. Cls. 601, where the taxpayer paid the tax to obtain possession of his property; Christie Street Co. v. U. S., 126 Fed. 991 (internal revenue cases).

178 Chesebrough v. U. S., 192 U. S. 253. The court cites Little v. Bowers, 134 U. S. 547; and Union Pacific Co. v. Dodge, 98 U. S. 541 in support of its conclusion.

179 The court held that an application to the Commissioner under § 3220 was not the statutory equivalent of a common law protest or notice of suit.

180 It appeared that the vendee was unwilling to accept an unstamped conveyance and that stamps were affixed in order to complete the transaction and obtain the consideration. But the court said that "if that constituted duress as between Chesebrough and his building company it was a matter with which the collector had nothing to do."

others.[181] In another case,[182] however, duress as to the stamp tax on manifests of cargoes was claimed in that clearance papers for vessels bound to foreign ports could not be obtained without stamped manifests without which in turn such vessels would be prevented from sailing and their masters liable to a penalty. The court held that such facts did not constitute duress. Further doubt has been thrown upon this entire question by a comparatively recent case,[183] in which the taxing statute in controversy contained self-executing or automatic provisions for its enforcement, whereby corporations failing to pay the tax forfeited their rights to do business within the state and incurred a penalty. The court said in part: "It is reasonable that a man who denies the legality of a tax should have a clear and certain remedy. The rule being established that, apart from special circumstances, he can not interfere by injunction with the state's collection of its revenues, an action at law to recover back what he has paid is the alternative left. Of course, we are speaking of those cases where the state is not put to an action if the citizen refuses to pay. In these latter he can interpose his objections by way of defense; but when, as is common, the state has a more summary remedy, such as distress, and the party indicates by protest that he is yielding to what he can not prevent, courts some times, perhaps, have been a little too slow to recognize the implied duress under which payment is made. But even if the state is driven to an action, if, at the same time, the citizen is put

[181] Note the following language of the court: "At the same time, when taxes are paid under protest that they are being illegally exacted, or with notice that the payer contends that they are illegal, and intends to institute suit to compel their repayment, a recovery in such suit may, *on occasion*, be had, although generally speaking, even a protest or notice will not avail if the payment be made voluntarily. * * * As we have said, the purchase of these stamps was purely voluntary, and if, *notwithstanding, recovery could be had, it could only be on protest or notice*, and there was none such here, written or verbal, formal or informal."

[182] U. S. v. N. Y. & Cuba S. S. Co., 200 U. S. 488. In this case as in Chesebrough v. U. S., 192 U. S. 253, the collector was not informed at the time of the purchase of the particular purpose for which the stamps were to be used, and no intimation was given him, written or oral, that the taxpayer claimed that the law regarding such stamps was unconstitutional and that it was making the purchase under duress. The court said that all determining conditions were the same as in the Chesebrough case.

[183] Atchison v. O'Connor, 223 U. S. 280. See also Gaar, Scott, & Co. v. Shannon, 223 U. S. 468, in which the court said in part: "Neither a statute imposing a tax, nor the execution thereunder, nor a mere demand for payment, is treated as duress. It does not necessarily follow that there will be *duress of goods*."

at a serious disadvantage in the assertion of his legal, in this case of his constitutional, rights, by defense in the suit, justice may require that he should be at liberty to avoid those disadvantages by paying promptly and bringing suit on his side. He is entitled to assert his supposed right on reasonably equal terms." A clearer definition than exists at present of the nature of, and necessity for a protest and duress in regard to the recovery of internal revenue taxes would be of material assistance both to the taxpayer and the government, since the present uncertainty, instead of freeing the courts from the undoing of the voluntary arrangements of parties not induced by fraud, accident or excusable negligence, is calculated to fill the courts with questions which do not go to the merits of taxation controversies. The more liberal rule of implied duress suggested by the Supreme Court in the case,[184] referred to above, if properly extended and applied, would relieve many taxpayers objecting in good faith to the imposition of a tax from the risk of incurring a penalty in order to come technically within the present rule as to involuntary payments.[185]

[184] Atchison v. O'Connor, 223 U. S. 280. Almost all taxing statutes now contain summary and other drastic remedies for failure to pay the tax at the appointed time. Under the presumption that officers of the law will fulfill their duties a considerable extension of the doctrine of duress implied from a statute imposing a tax might well be made without detriment to the government's interests. It is seldom that the government and the taxpayer are on equal terms or that the latter has any choice but to do what the government officials require. Indeed, the only alternative of a taxpayer may sometimes be as in Swift v. U. S., 111 U. S. 22, to submit to an illegal exaction or discontinue business. It would seem that a clear protest should always be required.

[185] It has been held by a district court in Greenport Basin Co. v. U. S., 269 Fed. 58, that under § 252 of the Revenue Act of 1918, a taxpayer is entitled to a refund as a matter of right and that protest and duress are not necessary in order to maintain an action for the recovery of taxes illegally assessed. The soundness of this decision seems extremely doubtful. § 252 relates solely to the matter of obtaining a credit or a refund and does not in any way bear upon the question of suing to recover taxes illegally assessed. The section was apparently designed to counteract the effect of § 3228 of the Revised Statutes, which limited refunds to a period of two years after the tax had been paid. There is no clear evidence of congressional intent to abolish the rule hitherto in effect, that in suing the government in the courts for the recovery of taxes erroneously paid, it was necessary to show that the taxes were paid under protest and duress. In other words, it has always been the rule that protest was not necessary in order to take any action within the treasury department by way of abatement or refund and the only effect of § 252 seems to be to extend the period of limitation and to enable the taxpayer to obtain a credit. The court in the same case says that even if protest and duress is necessary

in order to maintain a suit, it is sufficient if the defendant computed the tax "under compulsion of the Regulations and filed a claim for abatement of the taxes assessed before payment". This is said to comply with every requisite of a payment under protest. This statement may also be doubted in view of the decision in Rock Island & C. R. Co. v. U. S., 254 U. S. 141, when it was held that a claim for refund as distinguished from a claim in abatement is necessary as a prerequisite to suit. Mr. Justice Holmes in this case remarked that "men must turn square corners when they deal with the government". The court in the Greenport case also says that it would be "a useless requirement" to make protest at the time of actual payment. It should be noted, however, that a similar argument in the Rock Island case to the general effect that it would be a useless requirement to make a claim for refund after denial of the claim in abatement was unavailing. It also seems doubtful if the only principle underlying protest and duress is to "define the taxpayer's attitude and to notify the government thereof" as stated by the court. This may be true with regard to protest, but the necessity for protest should not be confused with the requirement that taxes cannot be recovered unless they are paid under duress. A claim in abatement or any statement to the treasury department outlining the taxpayer's objection to tax proposed to be assessed or assessed may constitute a sufficient protest to permit of recovery in the courts and yet the taxpayer may be precluded from recovery because he has paid the taxes in question without the necessary degree of coercion.

One of the most liberal cases upon the question of duress is the case of Underwood Typewriter Co. v. Chamberlain, (Conn.), 102 Atl. 600, 254 U. S. 113. In this case the state contended that the taxpayer had made a voluntary payment of the tax in question. The statute under which the tax was paid provided that the tax would become due on or before August 1; that ten days thereafter and upon notice and demand of payment, 5% of the unpaid tax would automatically be added to it and interest at the rate of three-fourths of one per cent. per month upon such tax from the date the tax became due would also be added; that the unpaid tax became a lien upon the real estate of the company within the state from the time the tax became due and was unpaid and from the filing of certificate signed by the treasurer in the land records of the town. In many respects these penalties closely resemble the penalties imposed for failure to pay the federal income tax. The Connecticut court said: "The company was confronted with this situation: Though it contested the validity of the tax successfully it could not prevent the filing of the lien upon its property. And if it were unsuccessful, no matter what merit its claims possessed the lien would attach, and the 5 per centum penalty and the 9 per centum interest would accrue. The lien might prove a serious burden upon its credit, while the actual pecuniary losses suffered or threatened involved a hardship and loss which no company should be compelled to face. It could not measure the extent of these penalties, because it could not know the time the tax litigation would take. It would be unfair to it to compel it to take this risk of loss as the condition of its right to test the validity of the tax. It should have that right without condition, and by a clear and certain remedy. This is common practice, and it is sound public policy. It is not to the advantage of the state that those whom it seeks to tax should refuse to pay their taxes in order to test their validity. Such a course if largely followed might cause the state more than an inconvenience in the disturbance of the budget upon which the payment of its gov-

PAYMENT AFTER RECEIPT OF FORM 1123. Form 1123, which under the 1918 Law was sent out ten days before the second, third and fourth due dates, made "demand" for the tax, but did not contain any threats of penalties to be exacted in the event of nonpayment. Under the strict rule with regard to duress a taxpayer might not safely pay each installment on the 15th day of the various months so far as the technical requirements of a suit to recover taxes are concerned.[186]

PAYMENT AFTER RECEIPT OF FIRST NOTICE AND DEMAND FOR TAX. The earlier form [187] of notice and demand for tax contained the following language: "Demand is here made for this tax. * * * If this tax is not in my hands for deposit before the close of business of the day above specified it will become my duty, under the law, to collect the same together with 5 per centum additional, and interest at 1 per centum per month until paid." The form[188] in use from 1916 until recently contains the following language: "If payment is not made within ten days from the above date, it will be my duty to collect the same with costs by seizure and sale of property." The form now in use contains the language: "Demand is made for the payment of the said tax on or before the date given below. Failure to do so will cause a 5 per cent. penalty to accrue with interest at 1 per cent. per month from due date until paid."[189] In a case in which a notice very similar in form to the first of the above notices and containing a threat to collect penalties and interest was served upon the taxpayer it was held that payment was clearly

ernmental obligations depended. The more orderly course is a compliance with the law by a payment, reserving the right to contest the validity of the required payment. The payment of the tax in question was not a voluntary one; it was in the contemplation of the law a payment under duress of the penalties of the act. And this we hold from a consideration of the provisions of the act and without a consideration of any remedies by way of distress which the state might have for the enforcement of payment of this tax. A payment of a tax made to avoid the onerous penalties of the act imposing the tax for its nonpayment is not a voluntary payment." (See also Home Tel. & Tel. Co. v. Los Angeles, (Cal.), 181 Pac. 815.)

[186] Neither should the tax be paid in advance, if it is objected to as illegal. For instance, payment of the four installments at the time of filing a return would probably preclude a taxpayer from relief in the courts. In Railway Co. v. Humboldt, 87 Kans. 1, 123 Pac. 727, the court stated that the payment of the second half of a tax, due in June, prior to December 20 of the preceding year, in order to obtain a rebate, was a voluntary payment and was therefore not recoverable.

[187] Form 1-17.

[188] Form 1-17.

[189] See Form 1-17 in its latest revision.

involuntary and under duress.[190] In another case [191] arising under the 1913 Law the Supreme Court allowed recovery when payment was made after receipt by the taxpayer of the first of the above forms of notice. It is a matter of doubt whether the form of notice and demand in use under the 1918 Law and not containing an express threat to collect the 5% penalty and interest, and containing no reference to any seizure and sale of property, but containing a statement that such penalty and interest would accrue, was sufficient to constitute a payment made thereafter involuntary.

PAYMENT AFTER RECEIPT OF SECOND NOTICE AND DEMAND FOR TAX. There can be no doubt that payment upon receiving the second notice and demand in use under the 1918 Law was clearly payment under duress, since that notice threatened the seizure and sale of the taxpayer's property to satisfy the tax, penalty, interest and costs.[192] If the taxpayer delayed payment until the receipt of such notice, in order that it might be shown that payment was clearly made under duress, penalty and interest was required to be paid. It was a wise precaution to protest not only against payment of the tax but also against payment of such penalty and interest as well.

Abatement, Credit and Refund. The taxpayer may file a claim for abatement of an assessment which he thinks is erroneous after the assessment has been made and before the tax is paid, or may file a claim for refund or credit of a tax which he thinks has been erroneously assessed after the tax is paid. A further discussion of this subject is contained in a later chapter on abatement and refund.[193]

Committee on Appeals and Review. An advisory tax board was created by the Revenue Act of 1918 for the reasons and with the organization and power indicated elsewhere in this book.[194] The function of the board was to review upon appeal the administrative decisions of the income tax unit in important income and excess-profits tax cases, particularly cases involving

190 Herold v. Kahn, 159 Fed. 608.

191 Gulf Oil Co. v. Lewellyn, 248 U. S. 71, reversing 245 Fed. 1, which had reversed 242 Fed. 709. In a case arising under the 1909 Law it was held that payment after a notice to the effect that if the tax together with interest was not paid, the collector would take steps to collect the same with penalties was involuntary. (Cambria Steel Co. v. McCoach, 225 Fed. 278.)

192 See Form 1-21.

193 See Chapter 37.

194 See Chapter 1. As to submission of questions and procedure for Advisory Tax Board, See Reg. 45, Arts. 1701-1702, no longer in effect.

exceptional or unusual conditions with respect to invested capital, amortization, depletion and depreciation. The committee on appeals and review took over this function.[195]

PROCEDURE. When an appeal is taken from a ruling of the income tax unit to the committee on appeals and review or a question is certified to that committee at the request of the taxpayer, and an oral presentation is desired, the record must immediately be examined to ascertain as to whether there is a question of law involved. If it is found that a question of law is involved, the solicitor must be notified and he will thereupon designate one member of the solicitor's office to sit with the committee and himself for the purpose of hearing the appeal, or if the solicitor finds it inconvenient to sit with the committee he may designate two members of his office to do so. At the hearing before the committee the taxpayer or his attorney or representative will be expected to make his full oral argument on the law as well as the facts, and this presentation will be the only oral presentation except in unusual circumstances, or unless a further argument of the facts or the law is deemed desirable by either the chairman of the committee or the solicitor. The attorney or attorneys so designated by the solicitor for the hearing will be expected, in conjunction with the solicitor and the conference committee in the solicitor's office, if the solicitor so desires, to consider the legal aspects of the case, and the solicitor's recommendation in the form of an opinion or memorandum will then be made to the chairman of the committee, and thereupon the committee's findings will be prepared and submitted to the Commissioner for his approval. In any case of appeal there must be filed with the committee, either at the time of filing the appeal or on or before the date set for oral presentation, if oral argument is desired, a succinct written statement of the essential facts which the taxpayer desires to have considered in connection with his appeal, duly sworn to. If the taxpayer, his attorney, or representative does not wish an oral argument, his argument may be made in the form of a written statement or brief which should be filed at the time the appeal is submitted to the committee. If an oral presentation is to be made, the taxpayer, his attorney, or representative may in addition thereto file such brief or briefs as he may desire. These briefs, not less than three copies of which should be furnished,

[195] I. T. S. 1921, § 2470.

may be either printed or typewritten, and where practicable should be filed not less than three days before the appeal is to be heard. Additional briefs may be filed at the time of or subsequent to the hearing within the time prescribed for the particular case by the committee.[196]

[196] O. D. 709, T. B. 43-20-1272.

CHAPTER 36

PENALTIES AND COMPROMISES

Several penalties are contained in the Revenue Act of 1921 for failure to comply with its provisions and for making false and fraudulent returns. The penalties take two general forms: (a) specific penalties of fines with maximum limits and imprisonment, and (b) penalties of either 5%, 25% or 50% based upon the tax. In the case of individuals specific penalties are held to attach to the person and are unenforceable after the death of such person. *Ad valorem* penalties (those based upon the tax) are enforceable regardless of the death of the owner of the income by which the penalty is measured.[1] An *ad valorem* penalty is assessed and collected as a part of the tax, while a specific penalty is recoverable only by suit.[2] In general, the penalties under the 1921 Law are the same as those provided by the Revenue Act of 1918. A 25% penalty is provided in the case of taxpayers violating, or attempting to violate, the provisions of the statute as to the collection of tax from those designing quickly to depart from the United States.[3] Certain other changes and additions are noted in the following paragraphs.

Suit to Enjoin Collection of Penalties. While the prohibition of suits to enjoin the collection of internal revenue taxes[4] does not specifically include "penalties" as such, yet where penalties are authorized by the statute to be added to the tax and collected as a part of the tax, the courts hold that the penalty is a part of the tax, and that its collection can not be enjoined.[5]

Failure to File Return. If an individual, corporation, or partnership fails to file a return, the specific penalty, where the failure is not wilful, is not more than $1,000.[6] In the case of such failure to file a return within the time prescribed by law,

1 Reg. 33 Rev., Art. 51. See U. S. v. Theurer, 213 Fed. 960; U. S. v. Pomeroy, 152 Fed. 279, reversed on different ground, 164 Fed. 324.

2 Reg. 45, Art. 1041.

3 See Chapter 35.

4 R. S., § 3224.

5 Kohlhamer v. Smietanka, 239 Fed. 408.

6 Revenue Act of 1921, § 253; Revenue Act of 1918, § 253. The courts are loathe to construe a statute so as to impose a penalty unless there has been a substantial delinquency. (Savings Bank v. Archbold, 104 U. S. 708.) Technically this provision imposes a penalty in cases where there has been no substantial delinquency. As a practical matter, such cases are compromised by the payment of nominal penalties (see page 910).

or by the Commissioner or collector, the Commissioner also adds to the tax 25% of its amount,[7] except as set forth in the next paragraph. Two classes of delinquents are liable to the penalty: (a) those who do not file returns and for whom returns are made by the collector or Commissioner; and (b) those who file tardy returns and are unable to show reasonable cause for the delay.[8]

EXCEPTIONS. When a return is filed after the time prescribed by law, and it is shown that the failure to file it was due to a reasonable cause and not to wilful neglect, the addition of 25% of the tax is not made.[9] Taxpayers wishing to avoid the penalty must make an affirmative showing of the facts alleged as a reasonable cause for failure to make a return on time in the form of an affidavit under oath, which should be attached to the return. If such an explanation is furnished with the return or upon the collector's demand, the collector, unless otherwise directed by the Commissioner, will forward the affidavit with the return, and if the Commissioner determines that the delinquency was due to a reasonable cause, the 25% penalty will not be assessed. "Reasonable cause" is such a condition of fact that had the taxpayer in default exercised ordinary business care and prudence it would have been impracticable or impossible for him to file a return in the prescribed time.[10] Where the attendant and surrounding circumstances have a tendency to cast doubt and suspicion upon a taxpayer, a plea of mere ignorance is not sufficient to constitute a reasonable cause for failure to make and file a return on time.[11] Where the United States, through the proper officer of the Indian Service, files a return of income for a restricted Indian, which is delinquent, no penalty will be asserted for such delinquency since

[7] R. S., § 3176, as amended by the Revenue Acts of 1921 and 1918. As this section of the Revised Statutes formerly read (as amended by the 1913 Law) a "refusal or neglect" was a condition to the addition of the *ad valorem* penalty provided. These words were held to mean neither a mere failure to file a return within the time required by law nor a failure to file a return at any time, but something in between these two extremes; that is, where there had been a refusal or inexcusable neglect. (L. O. 1060, T. B. 14-21-1554). The 50% addition to tax, now replaced by a 25% addition, has been held a penalty. (17 Ops. Atty. Gen. 433; 23 Ops. Atty. Gen. 398.)

[8] Reg. 45, Art. 1004. With regard to supplemental returns for years ending in 1918, see T. B. R. 31, T. B. 7-19-306.

[9] R. S., § 3176, as amended by the Revenue Acts of 1918 and 1921; S. 1359, T. B. 13-20-817.

[10] Reg. 45, Art. 1004; Reg. 33 Rev., Art. 54.

[11] O. 818, T. B. 3-19-204.

it is held that the penalty provisions of the law are inoperative against the government.[12]

Intentional Neglect or Refusal to Make Returns. Any individual, corporation or partnership wilfully refusing to make a return is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[13] In case of intentional neglect or refusal to make a return, the *ad valorem* penalty of 25% of the tax is also added. The amount so added is collected at the same time and in the same manner and as part of the tax, unless the tax has been paid before the discovery of the neglect, in which case the amount so added is collected in the same manner as the tax.[14]

False Returns. The law provides that if any deficiency in tax is due to fraud with intent to evade tax, then, in lieu of the penalty provided by the Revised Statutes,[15] as amended, for false or fraudulent returns wilfully made, but in addition to other penalties provided by law for false or fraudulent returns there shall be added as part of the tax 50% of the total amount of the deficiency.[16] The 1918 Law imposed the same penalty where the "understatement" was "false or fraudulent with intent to evade the tax." The term "understatement" had particular reference to the understatement of the amount of the tax in the return. This was true whether such understatement resulted from the false or fraudulent computation of the tax or

[12] O. D. 1130, T. B. 49-21-1966.

[13] Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.

[14] R. S., § 3176, as amended by the Revenue Acts of 1921 and 1918; Reg. 45, Art. 1004. Under the 1913 Law the *ad valorem* penalty of 100% was added. (T. D. 1950.) The inference of R. S. 3176, as then in force, is clear that for intentional failure to file a return only the 50% penalty should be added, and it is difficult to understand by what authority the 100% penalty was added for failure to make any return at all, even though the failure was intentional.

[15] R. S., § 3176, as amended by Revenue Acts of 1918 and 1921.

[16] Revenue Act of 1921, § 250; Revenue Act of 1918, § 250; O. 1008, T. B. 10-20-782. The law also provides that "in case a false or fraudulent return is wilfully made, the Commissioner shall add to the tax 50 per centum of its amount." The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity or fraud, in which case the amount so added shall be collected in the same manner as the tax. (R. S., § 3176, as amended by Revenue Acts of 1921 and 1918. See also Reg. 45, Art. 1005.) Under this provision before the Revenue Act of 1918, it was held that the corresponding penalty should be added to the amount of the tax shown by the correct return. (Reg. 33 Rev., Art. 53.)

from false or fraudulent misstatements or omissions of items of income or misstatements of items of deduction or from other false or fraudulent entries or omissions.[17] The above provision does not include returns which are false in the sense of containing mistakes or unintentional misstatements. A return may be false in the sense used in those sections of the law which permit summary assessments in the case of erroneous, false or fraudulent returns without being false in the sense of the section prescribing the penalty of 50%.[18] Under the 1918 Law, if a return made in good faith was false in the sense of being incorrect, but such falsity was due to negligence on the part of the taxpayer, "without intent to defraud," the 50% was not added, but a penalty of 5% of the total amount of any deficiency plus interest at 1% per month on the amount of the deficiency of each installment from the time such installment is due, was added. "Negligence on the part of the taxpayer, but without intent to defraud," was presumed to exist in every case in which a deduction had been made or income had been omitted in direct conflict with the specific provisions of the law and regulations, but was not presumed to exist if the understatement might be ascribed to an error of judgment as to some matter not so concluded.[19] Whether it would be held that negligence, without intent to defraud could exist where the taxpayer was known to have knowledge of the law and regulations, is not clear. Under the present law the 50% penalty is not imposed, but the 5% penalty is imposed and interest at 1% per month is added if any part of the deficiency is "due to negligence or *intentional disregard of authorized rules and regulations with knowledge thereof*, but without intent to defraud."[20] As indicated above, the treasury department in construing the 1918 Law, arrived at practically the same result as is reached by the more specific provisions of the present law, except that the present law now makes it certain that only the 5% penalty and interest attaches where the deficiency is due to intentional disregard of authorized rules and regulations *with knowledge thereof*. Under the present law, in case of any deficiency, interest will be added at the rate of one-half of 1% per month from the time the tax was due, or if paid on the installment basis, on the deficiency of each installment

17 O. 1008, T. B. 10-20-782.

18 Revenue Act of 1918, § 250; R. S., § 3176, as amended by Revenue Act of 1918. Eliot Nat. Bank v. Gill, 218 Fed. 600; Woods v. Lewellyn, 252 Fed. 106. See, however, U. S. v. Nashville etc. Ry. Co., 249 Fed. 678.

19 Revenue Act of 1918, § 250; A. R. M. 23, T. B. 7-20-746.

20 Revenue Act of 1921, § 250 (b).

from the time the installment was due except that where the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, interest will be added at the rate of 1% per month.[21] Under the 1918 Law no penalty was imposed in case a return made in good faith was false in the sense of being incorrect, in the absence of fault on the part of the taxpayer,[22] but this provision is not contained in the present law. Where an amended return showing additional tax liability has been filed, no interest on the additional tax will be collected unless 10 days after notice and demand by the collector the amount of the additional tax assessed has not been paid, provided there appears to have been no neglect or intent to defraud upon the part of the taxpayer.[23] In cases where an addition of 25% or 50% is made to the tax on account of delinquency or fraud, and the taxpayer fails to pay the tax within 10 days after notice and demand from the collector, the 5% penalty and interest attach not only to the amount of tax shown to be due by the return, but also to the 25% or 50% addition to the tax.[24] In general, negligence is attributable to the taxpayer if he computes the tax in disregard of the instructions on the return form or otherwise incorrectly, unless he can show that his error was due to an honest misunderstanding of the facts or the law of which an average reasonable man might be capable.[25] In addition to the *ad valorem* penalties above enumerated for making false and fraudulent returns, the making of such returns may subject the taxpayer to a fine of $10,000 and imprisonment for not more than one year, together with the costs of prosecution, for wilfully attempting "in any manner to defeat or evade the tax."[26] The penalties applying to false or fraudulent returns apply to amended as well as original returns.[27]

RED CROSS CONTRIBUTIONS. The penalty for negligence was not asserted against a corporation when a deduction was taken for contributions to the Red Cross or similar war works, but such item was specifically and separately listed in the schedules attached to the return.[28]

21 Revenue Act of 1921, § 250 (b).
22 Revenue Act of 1918, § 250.
23 O. D. 366, T. B. 2-20-678.
24 O. D. 441, T. B. 14-20-836.
25 Reg. 45, Art. 1005.
26 Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.
27 Levy v. U. S., 271 Fed. 942.
28 A. R. R. 360, T. B. 1-21-1377; T. D. 3105, T. B. 1-21-1385.

Appreciation in Value of Lumber Properties. A number of taxpayers engaged in the lumber business were advised by counsel that they were entitled to include the appreciation in the value of their properties in invested capital under the 1917 Law. Being also advised that they could not safely make a voluntary return along the lines insisted upon by the treasury department, and wishing to test the matter in the courts, these taxpayers included such appreciation in invested capital, calling specific attention on the returns to the fact that they had done so. Additional taxes were not assessed by the department prior to the making of their 1918 returns, and many of the taxpayers construed this failure to assess additional taxes as an acquiescence in the soundness of their position and made 1918 returns on the same basis. It was held that since a complete disclosure was made in the return no penalty should be asserted.[29]

Tax on Bank Stock. Banks which deducted 1919 taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such banks, have been held guilty of negligence and subject to the 5% penalty.[30]

Gains from Sales of Capital Assets. Taxpayers omitting to include in gross income gains derived from the sale of capital assets, in reliance upon decisions in the lower federal courts that such gains were not taxable, but making a full disclosure of the facts, were not subjected to the penalties for negligence or fraud.[31]

Fraudulent Returns. Where a false or fraudulent return is made, then, in addition to the other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50% of the amount of the deficiency. This increase is only made in case the return is fraudulently false.[32] The Revenue Act of 1921 provides that in such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector.[33] In a case in which a taxpayer in good faith and *without any fault* on his part failed to report certain items of income in his return and also *negligently* failed to report other items of income, and also *fraudulently* and with intent to evade the tax failed to report

[29] A. R. M. 105, T. B. 2-21-1392.

[30] O. D. 944, T. B. 23-21-1677.

[31] M. 2791, T. B. 23-21-1674.

[32] Revenue Act of 1921, § 250; Revenue Act of 1918, § 250. Nat. Bank of Commerce v. Allen, 223 Fed. 472.

[33] Revenue Act of 1921, § 250. This provision was not contained in the 1918 Law.

other items of income, it has been ruled that the return is to be dealt with as a whole; that no part of the deficiency or understatement is free from penalty if a part of the return is tainted with fraud or negligence; that the penalty of 5% of the whole amount of the deficiency does not attach because a greater penalty is provided, the statute making no provision for dividing up the deficiency and applying to various parts of it different penalties; that the penalty of 50% will be applied to the entire amount of deficiency or understatement which is tainted with fraud and not to simply a part thereof.[34] A taxpayer who filed a return of income which did not include profit on the sale of certain corporate stock and in reply to an inquiry by an examining officer stated that he had not made any money on outside investments during the year, but in reply to a direct inquiry in regard to the sale of the stock, based on confidential information, admitted the sale, but made no explanation of his failure to include the profit on the sale in his return for the taxable year, is held to have filed a false and fraudulent return for the purpose of evading taxation and the 100% additional tax should be assessed.[35]

Fine Against or Imprisonment of Officer of Corporation or Member of Partnership or Employee of Either. In case an officer of a corporation or member of a partnership or an employee of either, charged with the duty and responsibility of making a return, paying or collecting the tax, or supplying information at the source, wilfully refuses to make such return, pay or collect such tax, or to supply such information, or attempts in any manner to defeat or evade the tax, he is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[36]

Returns of Information at Source. Any individual, corporation or partnership called upon to supply information at the source, who fails to do so at the time or times specified in each year, when such failure is not wilful, is liable to a penalty of not more than $1,000. If such failure to file information at the source is wilful, the delinquent is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[37]

[34] O. 1028, T. B. 18-20-903.

[35] S. 926, T. B. 1-19-105. This ruling was made under the 1913 Law.

[36] Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.

[37] Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.

Returns of Withholding Agents. Failure to make and file withholding returns on or before March 1st renders a withholding agent liable to the specific penalty of not more than $1,000[38] unless the tax is paid by the recipient of the income.[39] If the failure of the withholding agent was fraudulent and for the purpose of evading the tax, however, he will be guilty of a misdemeanor and fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution, irrespective of whether or not the tax is paid by the recipient of the income.[40] The *ad valorem* penalties for *fraudulent* returns should be assessed against withholding agents under the income-tax provisions of the law. The *ad valorem* penalties for *delinquent* returns should be assessed against withholding agents, except that if the tax required to be withheld is paid by the recipient of the income, no such penalty should be collected from the withholding agent unless his delinquency was fraudulent and for the purpose of evading payment.[41]

Attempts to Evade the Tax. Any individual, corporation or partnership wilfully attempting in any manner to defeat or evade the tax is guilty of a misdemeanor and may be fined not more than $10,000, or imprisoned for not more than one year, or both, together with the costs of prosecution.[42] This includes a tax yet to be assessed as well as a tax already assessed.[43] The giving of instructions or advice with the purpose and intent of inducing

38 Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.

39 Revenue Act of 1921, § 221 (e); Revenue Act of 1918, § 221 (e).

40 Revenue Act of 1918, §§ 253, 221 (e).

41 S. 1334, T. B. 8-20-758, apparently overruling Mimeograph Letter to Collectors, No. 1265.

42 Revenue Act of 1918, § 253. The following comment of Mr. Justice Holmes in Bullen v. Wisconsin, 240 U. S. 625, is interesting in this connection: "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law." The distinction between a legal avoidance and an illegal evasion must be kept in mind (see U. S. v. Isham, 17 Wall. 476, 84 U. S. 496; S. 1385, T. B. 19-20-928; L. O. 1062, T. B. 14-21-1548, overruling L. O. 1035, T. B. 10-20-1222). The fact that a transaction has for its purpose the reduction of taxes does not make it illegal if the means employed are in themselves legal. As to taxpayers violating or attempting to violate the provisions of the law respecting taxpayers designing to depart from the United States, see Chapter 35.

43 Levy v. U. S., 271 U. S. 942.

persons liable to make returns or pay tax to refrain from making returns or paying tax is an attempt to defeat the tax.[44]

Failure to Pay Tax. Any individual, corporation or partnership failing wilfully or otherwise to pay the tax at the time or times required is liable to the same specific penalties which attach for failure to make a return accordingly as such failure is or is not wilful.[45] In addition, as set forth in another chapter [46] interest will be added, the tax will become a lien, and the goods, chattels or effects, including stocks, securities and evidences of debt, of the taxpayer will be subject to distraint and sale.

Delay in the Payment of the Tax. As a general rule, if any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, there will be added as part of the tax the sum of 5% on the amount due but unpaid, and interest at the rate of 1% per month upon such amount from the time it became due. This penalty and interest do not accrue in case of any tax due from the estates of insane, deceased or insolvent persons. When an assessment has been made for a tax or penalty and a *bona fide* claim for its abatement is filed within ten days after demand for payment, where the taxpayer has not had the benefit of the provision of the 1921 Law allowing him 30 days in which to file an appeal, the time ceases to run against the claimant as to the 5% penalty, from the time the tax was due until the claim is decided. Upon receipt of a notice of rejection of the claim or so much thereof as is not allowed the collector will notify the claimant and demand payment of the tax. If the tax is not then paid within 10 days, the 5% penalty will be assessed on the amount of tax not abated. If abatement of the entire tax assessed is not demanded in a claim, and the balance of the tax is not paid within the required 10 days, the 5% penalty will immediately accrue on such balance.[47] Under the 1918 Law, interest at the rate of one-half of 1% per month, in any event, ran from the time the tax was due until the claim was decided, notwithstanding that a claim for abatement had been filed.[48] Where a warrant of distraint was served, $5 was added.[49] Under the present law interest from the

[44] S. 931, T. B. 1-19-108.

[45] Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.

[46] See Chapter 35.

[47] Revenue Act of 1921, § 250 (e); Revenue Act of 1918, § 250 (e); Reg. 45, Art. 1006; Reg. 14, October 15, 1916; Reg. 1., p. 110. For the rules when property passed into the hands of the alien property custodian prior to the expiration of the 10 days, see O. 1026, T. B. 17-20-876.

[48] Revenue Act of 1918, § 250 (e). See Chapter 37.

[49] Reg. 45, Art. 1006.

time the amount was due until the claim is decided will be at the rate of one-half of 1% per month on that part rejected.[50] In cases where delinquent returns are filed and the total tax is paid at the time of filing, the penalty of 5% and interest at the rate of 1% per month attaches only to the amount of any installment overdue.[51]

Where a taxpayer filed an amended return showing a lesser amount of tax due than that shown in his original return, but did not file a claim for abatement of the excess tax until after 10 days following notice and demand from the collector, assuming that the amended return was a substitute for the original return, the claim subsequently being rejected, it has been held that the 5% penalty and the 1% interest must be asserted for failure to pay the tax within 10 days after notice and demand. "Reasonable cause" is associated only with the 25% penalty in case of failure to file return within the time prescribed, and will not relieve a taxpayer from penalties incident to failure to pay any tax due within 10 days after notice and demand.[52] But if such claim were allowed, no penalty would be asserted.[53] A taxpayer having filed his return and paid the first installment of tax is aware of his liability to pay the balance of the tax on the respective due dates, and failure to receive notice and demand for the payment of the later installments by reason of his absence from this country does not constitute a sufficient cause for waiving the penalty and interest on any installment of the tax not paid when due.[54]

Penalty for Divulging Information. The penalty in the case of any collector, deputy collector, agent, clerk or other officer or employee of the United States who divulges information in his possession and acquired in the performance of his duties, is treated elsewhere in this book.[55]

Statute of Limitations. The Revenue Act of 1921, amending a prior statute, provides[56] that no person shall be prosecuted, tried or punished for any of the various offenses arising under the internal revenue laws of the United States unless the indictment

[50] Revenue Act of 1921, § 250 (e).

[51] O. D. 1111, T. B. 47-21-1935, overruling O. D. 313, T. B. 25-19-588.

[52] O. D. 706, T. B. 43-20-1268.

[53] O. D. 846, T. B. 11-21-1511.

[54] O. D. 408, T. B. 9-20-775.

[55] T. D. 2903; R. S., § 1767, as amended by Revenue Act of 1921; O. 907, T. B. 18-19-489. See Chapter 34.

[56] Revenue Act of 1921, § 1321, amending the act entitled "An act to limit the time within which prosecutions may be instituted against persons charged with violating internal revenue laws", approved July 5, 1884.

is found or the information instituted within three years next after the commission of the offense, except that the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings. Where a complaint is instituted by a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district. The above provisions do not apply to offenses committed by officers of the United States.[57] The Revised Statutes provide that no suit or prosecution for any penalty or forfeiture, pecuniary or otherwise, accruing under the laws of the United States, shall be maintained, except in cases where it is otherwise specially provided, unless the same is commenced within five years from the time when the penalty or forfeiture accrued. The statute does not run, however, if the person liable for the penalty is not to be found within the United States so that proper process may be instituted and served against him.[58] The period of limitation applies whether the action is *in personam or in rem*.[59] The courts have no power to engraft any exception on this statute in cases of concealed fraud which is not discovered until after the expiration of five years.[60] The states can not pass any statute of limitations which will bind the federal government, or which will furnish the rules for determining whether an action is brought in time, except as Congress has clearly manifested its intention that the United States shall be so bound.[61] It has been held that where an income tax return under the Revenue Act of 1918 has been found to be false and fraudulent and the additional tax has been assessed and paid at a time when

[57] This act, as amended by the Revenue Act of 1921, also provides that "the provisions of this Act shall not apply to offenses committed prior to its passage" and that "any prosecution or proceeding under an indictment found or information instituted prior to the passage of this Act shall not be affected in any manner by this amendment, but such prosecution or proceedings shall be subject to the limitations imposed by law prior to the passage of this act".

[58] R. S., § 1047. Unless tax liability is discovered within three years from the time the returns were due under the 1909, the 1913 and the 1916 Laws, the commissioner has no authority to assess the 100% *ad valorem* penalty for false or fraudulent returns in the absence of a waiver of the rights as to the limitation of assessment of such penalties. (Sol. Op. 60, T. B. 36-20-1189; O. D. 530, T. B. 22-20-977.) See Chapter 35.

[59] Hatch v. The Boston, 3 Fed. 807, 810.

[60] U. S. v. Maillard, 26 Fed. Cas. No. 15,709.

[61] Arnson v. Murphy, 109 U. S. 238; U. S. v. Nashville Rd. Co., 118 U. S. 125.

the grounds for asserting the 50% fraud penalty were fully known to the treasury department, the penalty may still be thereafter assessed.[62]

There is sufficient valid consideration to support the acceptance of an offer in compromise of a specific penalty made by the taxpayer, even though the action thereon is barred by the statute of limitations.[63] Offers in compromise rest upon the same legal principles as ordinary contracts.[64] While there are cases holding that the acceptance of an offer relates back to the date of the offer, the general rule in ordinary cases is that the date of a contract is the date of its acceptance.[65] Therefore, if a claim of the government for penalties is without any foundation at all, either in law or in equity, there is not sufficient consideration for compromise. If, on the other hand, the government does surrender its claim and the claim has some foundation, either in law or in equity, there is sufficient consideration. Since the statute of limitations relating to penalties does not extinguish the cause of action but merely bars the remedy of the government and the statute of limitations is not a question of jurisdiction but of personal defense, an offer in compromise may legally be accepted after the expiration of the period of limitation.[66] Consequently, when an offer in compromise is made before the expiration of the period and is not withdrawn, it has been ruled that the failure to withdraw can be considered as a renewal of the offer to meet changed conditions and may be properly and legally accepted.[67]

Compromise of Taxes and Penalties. The Commissioner, with the advice and consent of the Secretary, may compromise any civil or criminal case arising under the internal revenue laws instead of commencing suit thereon; and, with the advice and

[62] Sol. Op. 52, T. B. 36-20-1188. The rule under the 1916 Law was different. Under that law and the Revenue Act of 1917, if the additional tax had been assessed but not paid, or paid but not assessed, the penalty might be asserted; but if it had been both assessed and paid, the penalty could not be asserted. Under all three of these acts, if the additional tax has been assessed or paid, or assessed and paid prior to discovery of the fraud, the penalty may be assessed at any time after the discovery and within the statutory period for assessment of taxes.

[63] Sol. Op. 7, T. B. 25-20-1019.

[64] Boughton v. U. S., 12 Ct. Cl. 330.

[65] Williston on Contracts, Vol. 1, §§ 96-97.

[66] See Taylor v. Weeks, 129 Mich. 233, 88 N. W. 466; Burriss v. Starr, 165 N. C. 657, 81 S. E. 929; Herrington v. Davitt, 220 N. Y. 162, 115 N. E. 476, 1 A. L. R. 1700.

[67] Sol. Op. 7, T. B. 25-20-1019.

consent of the said Secretary, and the recommendation of the Attorney-general, he may compromise any case after a suit thereon has been commenced. Whenever a compromise is made in any case the opinion of the solicitor of internal revenue or of the officer acting as such, with his reason therefor, with a statement of the amount of tax assessed, the amount of additional tax or penalty imposed by law in consequence of the neglect or delinquency of the person against whom the tax is assessed, and the amount actually paid in accordance with the terms of the compromise, must be placed on file in the office of the Commissioner. Accordingly, the power to compromise extends to (a) both civil and criminal cases; (b) cases whether before or after suit; and (c) both taxes and penalties, except that taxes legally due from a solvent taxpayer may not be compromised.[68] Subject to the limitation that he must act with the advice and consent of the Secretary (and the Attorney-general, if suit has been commenced), the Commissioner has power to compromise penalties and interest claims whenever, in his judgment, such a compromise is for the interest of the United States. Congress has not said that such compromises may be made only when in the judgment of the Commissioner more money can thereby be realized than can be realized by commencing and prosecuting a suit. It cannot be said, therefore, as a matter of law, that the power to compromise is limited to cases in which either the liability for the penalty or the collectibility of the claim is doubtful. The judgment of the Commissioner as to what is for the interest of the United States is conclusive, and what considerations shall control depend upon his discretion and sound judgment exercised in good faith. It may be that with respect to the amount of tax to be collected or the amount of penalty resulting from wilful fraud, the Commissioner may never find a case in which he will feel justified in accepting less than can be legally collected, whereas in cases of penalties resulting from accident, negligence, or technical omission he may honestly believe that the interest of the United States will be best served by accepting less than the full penalty. He has the right to compromise upon any ground which in his judgement renders the compromise for the interest of the United States.[69] The Commissioner has under this section no power to compromise a suit against the government,[70] the

[68] R. S. §§ 3229, 3469; Reg. 45, Art. 1011; S. 1371, T. B. 24-20-1006; O. D. 799, T. B. 6-21-1438.

[69] Op. Atty. Gen., June 3, 1919; I. T. S. 1921, ¶ 2149.

[70] 23 Op. Atty. Gen. 507.

power being limited to suits which the government may prosecute. A compromise operates for the protection of the offender against subsequent proceedings as fully as a formal conviction or acquittal, and is a bar to further action.[71] Where an action is brought by the United States against a delinquent taxpayer for having failed to file a return, the verdict must specifically state the amount of the penalty, after which the only remedy of the defendant (other than an appeal) is to apply for a compromise.[72] Offers in compromise should include payments of costs.[73] The amount of the offer should be deposited with the Commissioner, but cannot be held or set off against the tax due.[74] Refunds cannot be made of offers in compromise where it is subsequently ascertained that no violation of law was involved.[75]

SPECIFIC PENALTIES. While the sections of the revised statutes relating to compromise[76] do not in express language refer to the compromise of the specific penalty for failure to file the return, neither are they restricted in terms, nor by any reason of public policy, to penalties for the nonpayment of taxes. In the opinion of the Attorney-general the application of these sections to the compromise of penalties for failure to file returns in time is proper, and, further, in such compromises the Commissioner is authorized to consider not only the pecuniary interests of the treasury, but also general considerations of justice, equity and public policy.[77]

AD VALOREM PENALTIES. Congress has left it to the judgment and discretion of the Commissioner to determine when it is to the interest of the United States to compromise the *ad valorem* penalties imposed for failure to file returns, for false and fraudulent returns, for nonpayment of taxes when due, and interest, instead of commencing or prosecuting suits therefor. The only limitation placed upon the exercise of this judgment and discretion is that the Commissioner's action shall be with the advice and consent of the Secretary (and Attorney-general if suit has been commenced). Subject to this limitation the Commissioner has power to compromise such penalties and interest, whenever, in his judgment, such a compromise is for the interest of the

71 U. S. v. Chouteau, 102 U. S. 603; Rau v. U. S., 260 Fed. 131.
72 U. S. v. Acorn Roofing Co., 204 Fed. 157.
73 O. 907, T. B. 18-19-489; T. D. 642, March 20, 1903.
74 Boughton v. U. S., 12 Ct. Cls. 330.
75 Reg. 45, Art. 1011.
76 R. S., §§ 3229, 3469.
77 29 Op. Atty. Gen. 217.

United States.[78] Where a liability to an *ad valorem* fraud penalty exists, it may at any stage be compromised by the Commissioner and the approving officials, whether or not it has been formally assessed.[79]

OFFERS IN COMPROMISE. Under the 1918 Law, when returns of income or returns of information at the source were filed after their due dates, the specific penalty was asserted unless it could be shown that the delay was due to a reasonable cause, and offers in compromise were accepted in minimum amounts as follows: (1) Delinquent returns of income and information by individuals, $5; and (2) delinquent returns of income by corporations, $10. Such offers were received where the neglect of the taxpayer was not intentional.[80] Offers in compromise do not receive favorable consideration in cases where returns for the year in question have not been filed, but such offers are accepted "subject to the filing of the return."[81] All delinquents who do not compromise their liabilities to the specific penalty, after ample opportunity, are reported to the United States district attorney for proceedings.[82] It is the duty of every district attorney to prosecute every case for the collection of a fine, penalty or forfeiture reported to him by any collector, unless, upon inquiry and examination, he decides that such proceed-

78 Op. Atty. Gen. dated June 3, 1919; I. T. S. 1921, ¶ 2149. See T. D. 2871; O. D. 539, T. B. 23-20-990. A penalty (50%) corresponding to the penalty of 25% increase in tax for failure to file returns is found in practically all revenue laws relating to special taxes, and one construction has been that no administrative officer is clothed with authority to compromise such increase in tax. (T. D. 1701.) It has been held that the income tax law is explicit and mandatory in its provisions relative to the additional assessment of 25% of the tax otherwise due, in case of failure to file a return of income within the prescribed time except when a return is filed after such time and it is shown that the failure was due to reasonable cause and not to wilful neglect, does not give discretionary authority for remission of these additional taxes to any officer of the government. Congress passed an act providing particularly for the refund of such additional taxes, assessed under the 1909 Law, for neglect to file returns, but no such statute has been passed with respect to penalties incurred under the 1913, 1916, 1918 or 1921 Laws. (Act of March 3, 1913.)

79 L. O. 1072, T. B. 41-21-1864.

80 Mimeograph Letter to Collectors, No. 2077, dated March 13, 1919. Cards, Form 7245A, prepared in the manner indicated in M. 1480, dated February 26, 1917, should accompany every original delinquent return filed after the last dates for filing returns before the specific penalty will be asserted. (See also mimeograph letter to collectors, No. 1480, dated February 26, 1917; T. D. 2311; T. D. 2349.)

81 T. D. 2311.

82 T. D. 2311.

ings cannot properly be sustained, or that the needs of public justice do not require that such proceedings be instituted; in which case he reports the facts to the Commissioner for his direction.[83] Under the 1864 Law as amended in 1870 only one penalty was permitted to be recovered for all failures to make a return prior to the commencement of the action for the collection of a penalty.[84] Where an offer in compromise is accepted by the government, but no release is tendered by the government before the death of the taxpayer, his estate is not bound by the contract of compromise.[85]

Duty of Collector Regarding Violations of the Law. It is the duty of every collector of internal revenue having knowledge of any wilful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.[86]

83 R. S., § 838.

84 U. S. v. Brooklyn etc. Ry. Co., 14 Fed. 284; U. S. v. N. Y. Guaranty Co., 8 Ben. 269.

85 U. S. v. Richardson, 9 Fed. 804.

86 R. S., § 3164, as amended by Revenue Act of 1918 and re-enacted as amended by § 1311 of the Revenue Act of 1921.

CHAPTER 37

ABATEMENT, CREDIT, REFUND AND RECOVERY OF TAXES

The prompt collection of the revenue and its faithful application is one of the most vital duties of government. Depending, as the government does, upon its revenue to meet not only its current expenses, but to pay the interest on its debt, it is of the utmost importance that it should be collected with dispatch, and that the officers of the treasury should be able to make a reliable estimate of means in order to meet liabilities. It would be difficult to do this, if the receipts paid into the treasury were liable to be taken out of it, on suits for alleged errors and mistakes, concerning which the officers charged with the collection and disbursement of the revenue had received no information. To guard against such consequences, Congress has from time to time passed laws on the subject of the revenue, which not only provide for the manner of its collection, but also point out a way in which errors can be corrected. These laws constitute a system which Congress has provided for the benefit of those persons who complain of illegal assessments of taxes and illegal exactions of duties. The party aggrieved can test the question of the illegality of an assessment or collection of taxes by suit; but he can not do this until he has taken an appeal to the Commissioner. In other words, the person who believes he has suffered wrong at the hands of the collector can appeal to the courts; but he can not do this until he has taken an intermediate appeal to the Commissioner, and, in any event, he is barred from bringing a suit, unless he does it within the period limited by law. The object of these different provisions is apparent. While the government is desirous of securing to the citizen a mode of redress against erroneous assessments or collections, it says to him: "We want all controverted questions concerning the revenue settled speedily, and if you have complaint to make, you must let the Commissioner know the grounds of it; but if he decides against you, or fails to decide at all, you can test the question in the courts if you bring your suit within a limited period of time."[1] The Commissioner, subject to regulations prescribed by

[1] U. S. v. Savings Bank, 104 U. S. 728. See also Nichols v. U. S., 7 Wall. 122, modified in regard to its holding that cases under the revenue laws were not within the jurisdiction of the court of claims in U. S. v. Kaufman, 96 U. S. 567 and U. S. v. Savings Bank, 104 U. S. 728.

the secretary, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed, or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected.[2] The Revenue Act of 1918 contained a new provision authorizing the crediting against any income, war-profits or excess-profits taxes due, or any installment thereof, of any amount of income, war-profits or excess-profits taxes paid in excess of that due under the Act of August 5, 1909, the Act of October 3, 1913, the Revenue Act of 1916, as amended, or the Revenue Act of 1917. It also authorized the immediate refunding of any balance of such excess payment.[3] This provision is amended by the Revenue Act of 1921, as indicated below in this chapter. The principal changes made by the Revenue Act of 1921 discussed in this chapter bear upon the statutes of limitation upon the recovery of taxes and penalties from the Commissioner or in the courts, and the provision allowing interest to the taxpayer in certain cases.

Who May Claim Recovery of Tax. As a general rule, the taxpayer against whom the tax is assessed and by whom the tax is paid is the one who is entitled to claim abatement or refund or sue for its recovery. If the person against whom the tax is assessed is dead, the claim should be made in the name of the executor or administrator.[4] In cases where the tax has been withheld at the source the claim for abatement or refund may be made either by the withholding agent against whom the assessment was made or by the person for whose account such taxes were withheld.[5] Where one corporation had leased all of its property to another, a tax being thereafter assessed upon the lessor, and its claim for an abatement being rejected, the tax was paid

2 R. S., § 3220, as amended by the Revenue Act of 1918 by striking out the words "on appeal made to him (commissioner of internal revenue)."

3 Revenue Act of 1918, § 252.

4 Reg. 33 Rev., Art. 266. Certified copies of the letters of administration, letters testamentary or other similar evidence should be annexed to the claim in such cases.

5 Reg. 33, Art. 33. If an individual who received during 1917 interest on bonds containing a tax-free covenant clause was not liable to the payment of normal income tax for that year, the amount of tax paid at the source in his behalf by the debtor corporation is refundable to the debtor corporation, if such tax was not actually withheld from the individual bondholder. The amount of any income or excess-profits taxes, or any installment thereof, shown to be due on the debtor corporation's income and profits tax return may be credited with the amount of the excess tax in question paid at the source. (O. D. 1103, T. B. 46-21-1924.)

by the lessee to avoid the penalty threatened by the collector and to avoid distraint and sale of the leased property. The court held that the payment by the lessee was not voluntary and that it was entitled to sue for its recovery without regard to privity of contract between it and the collector.[6] In view of the fact that the statutes of New Jersey under which a merger or consolidation of corporations resulting in the formation of another corporation is accomplished provide, in effect, that the successor corporation shall represent predecessor corporations in the enforcement of their rights, it is held that the successor corporation is entitled to file claim for credit on account of the overpayment of tax by the predecessor corporation.[7] A taxpayer, the sole proprietor of several enterprises, who in 1917 filed in error partnership returns and paid the taxes due thereon in addition to taxes under his individual return, may apply the erroneous payment of taxes due on account of the returns of these nonexistent partnerships as a credit against taxes due on his amended individual returns for 1917 and subsequent years.[8]

Abatement. A claim in abatement is applicable to taxes which have been assessed but not yet paid. The Commissioner obtains jurisdiction to pass upon a claim and the merits of a case come before him only when a proper claim has been made. Under a claim for abatement he can only determine whether or not the assessment should be abated. Any further action would be in violation of the regulations and beyond his jurisdiction.[9] The Commissioner possesses no equity powers in case of abatement; if the tax is a legal one he can not abate it.[10] It seems that the Commissioner has no authority to revoke the abatement of a tax once made by him, but he may re-assess the tax.[11] The five-year statutory period of limitations does not apply to claims for abatement.[12]

Effect of Rejection of Claim for Abatement. It is now settled by the Supreme Court that the rejection of a claim in abatement does not dispense with the necessity of a claim for refund as a prerequisite to recovery in the courts, even though it

[6] Cambria Steel Co. v. McCoach, 225 Fed. 278.

[7] O. D. 950, T. B. 24-21-1690.

[8] O. D. 962, T. B. 26-21-1710.

[9] Rock Island etc., Rd. Co. v. U. S., 254 U. S. 141; Hastings v. Herold, 184 Fed. 759.

[10] Decision No. 180, 36 Int. Rev. Rec. 13.

[11] U. S. v. Alexander, 110 U. S. 325.

[12] O. 833. T. B. 4-19-235.

may seem a useless form to appeal to the Commissioner for a second time.[13]

PROCEDURE FOR CLAIMING ABATEMENT. Claim for abatement of taxes or penalties erroneously or illegally assessed, or which are abatable under remedial acts, must be made out on the form prescribed by the government[14] and must be sustained by the affidavits of the parties against whom the taxes were assessed, or of other parties cognizant of the facts.[15] The practice is to obtain the official form from the local collector, prepare it according to instructions and file it with the local collector. The claim for abatement can only be made between the time the tax is assessed and the date it is due. If the claim has not been acted upon within ten days after notice and demand for the tax, 5% penalty for failure to pay the tax will not accrue if the tax is paid within ten days after the claim for abatement is rejected, and interest from the time the amount was due until the claim is decided will be at the rate of ½% per month instead of 1%. The rule waiving penalty and reducing interest obtains only as to any amount of tax which is the subject of a *bona fide* claim for abatement.[16] When a tax has been assessed and turned over to the collector, the presumption is that the assessment is correct. The burden of proof in rebutting the presumption and showing that it was improperly or illegally assessed, or that relief should be given under a remedial statute, rests upon the applicant for abatement. The affidavits must therefore contain full and explicit statements of all the material facts relating to the claim in support of which they are offered and to the proper consideration of which they are essential. The filing of a claim for abatement does not necessarily operate as a suspension of the collection of the tax or make it any less the duty of the collector to exercise due diligence to prevent the collection of the tax being jeopardized. Under the Revised Statutes[17] every collector is

[13] Rock Island etc., Rd. Co. v. U. S., 254 U. S. 141, affirming the doctrine of Hastings v. Herold, 184 Fed. 759, and overruling Loomis v. Wattles, 266 Fed. 876; Weaver v. Ewers, 195 Fed. 247; Grier v. Tucker, 150 Fed. 658; Schwarzchild & Sulzberger Co. v. Rucker, 143 Fed. 656; De Bary v. Dunne, 162 Fed. 961; San Francisco Society v. Cary, 2 Sawy. 393, and T. D. 1293, T. D. 974. In the Rock Island case the court made the interesting remark that "men must turn square corners when they deal with the government".

[14] The form prescribed by the government is known as Form 47.

[15] Reg. 45, Art. 1032. Reg. No. 14 Rev. October 15, 1911, as modified by T. D. 2654.

[16] Revenue Act of 1921, § 250 (e); Revenue Act of 1918, § 250 (e).

[17] R. S., § 3218.

charged with the whole amount of taxes, whether contained in lists transmitted to him by the Commissioner or by other collectors, or delivered to him by his predecessor in office, and he is credited only with all payments into the treasury made as provided by law, and with the amount of taxes contained in the lists transmitted by him to other collectors and by them receipted for, and also with the amount of taxes of such persons as may have absconded or become insolvent prior to the day when the tax ought to have been collected, and with all uncollected taxes transferred by him to his successor in office, and this is conditioned upon proof, to the satisfaction of the Commissioner, that due diligence was used by him in his endeavor to collect the tax. There is no provision of law or of the regulations for crediting a collector with any amount of tax which he might be unable to collect by reason of a decrease in the assets of a taxpayer subsequent to the transmission of the list to him, and in no case is he relieved of liability for the amount of the tax in the absence of due diligence in endeavoring to collect it. While there is no provision of law expressly authorizing the collector to require a bond as a condition of suspending the collection of the tax, he is personally charged with the amount of the assessments made against taxpayers in his district and he is required to use due diligence in collecting such taxes. If he fails to exercise due diligence, it is clear that he becomes personally liable for any tax which may be lost through such failure. He may require the tax to be paid and leave the taxpayer to his remedy by a claim for credit or refund, and if he sees fit to suspend the collection of the tax in any case where a final collection may thus be jeopardized, he does it at his own risk. It is within his discretion to protect himself by requiring the taxpayer to execute a bond in the amount of the tax collection of which is postponed.[18] Where property of a corporation is in the hands of a receiver who files a claim for abatement of an additional assessment of income and profits taxes for 1917, no bond will be required as security for the payment of such taxes.[19] A claim for abatement of an apparently excessive tax assessed on the basis of a tentative return filed under the Revenue Act of 1918 would not be considered prior to the filing of a completed return.[20]

[18] O. 957, T. B. 31-19-652; Reg. 45, Art. 1032; A. R. R. 331, T. B. 48-20-1323.

[19] O. D. 733, T. B. 47-20-1316.

[20] O. D. 634, T. B. 33-20-1139.

PAYMENT WHERE CLAIM FOR ABATEMENT DENIED. Where a *bona fide* claim for abatement or a claim for credit is rejected, the tax which is the subject of the claim is chargeable with interest at the rate of one-half of 1% per month from the time the tax was due until the claim is decided adversely to the taxpayer; notice of the adverse decision is sent to the collector who must send to the claimant a notice and demand for payment of the assessment; if the tax is paid within the 10-day period following the sending of the notice, the 5% penalty is not collectible, and the only interest collectible is that at the rate of one-half of 1% per month from the time the tax was due until the date of the Commissioner's decision; if the tax is not paid within the 10-day period, the 5% penalty attaches in addition to the above interest and also interest at the rate of 1% per month from the date of the adverse decision by the Commissioner to the date of payment.[21]

Effect of New Provision for Appeal from Additional Assessments. Although retaining the provisions indicated in the foregoing paragraphs that as to any amount which is the subject of a *bona fide* claim for abatement interest shall be limited to one-half of 1%, the Revenue Act of 1921 contains a new provision for notification of the taxpayer and an appeal with hearing in regard to additional taxes proposed to be assessed by the Commissioner.[22] Where the taxpayer has had the benefit of this provision no abatement claim will be entertained.[23] The law, therefore, limits the rule that interest upon a *bona fide* abatement claim shall be at the rate of one-half of 1% to cases in which the taxpayer has not had the benefit of an appeal and hearing.[24] Such provision limiting the interest in the case of *bona fide* abatement claims will still apply, however, in cases in which the benefit of an appeal and hearing is withheld because the collection of the tax will be jeopardized by delay, and also to cases in which the taxpayer discovers that he has returned an excessive tax but has not yet paid the whole thereof, and files a claim for abatement against subsequent installments covering such excess. The practice upon the appeal from an additional assessment under the new provision of the 1921 Law above indicated must be determined by regulations. It does not seem neces-

[21] Sol. Op. 32, T. B. 31-20-1106.

[22] This provision is discussed in Chapter 35.

[23] Revenue Act of 1921, § 250 (d).

[24] Revenue Act of 1921, § 250 (e).

sary to require the filing of abatement claims, since the assessment itself is withheld until the determination of the hearing and appeal.

Credit and Refund. Prior to the passage of the Revenue Act of 1918, the fact that the taxpayer has overpaid his taxes for a previous year could have no effect upon the amount of tax for which he is liable for a different year. Consequently, when such conditions existed the only course which the government could pursue was to collect the present amount in full and permit the taxpayer to file a claim for refund of any amount overpaid. Congress, recognizing the injustice and hardship frequently involved in such an awkward procedure, provided for crediting the amount of any overpayment against taxes presently due.[25]

The Commissioner is authorized to allow credits and refunds by virtue of the following provision:[26]

"That if upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled 'An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes,' the Act of October 3, 1913, entitled 'An Act to reduce tariff duties and to provide revenue for the government, and for other purposes,' the Revenue Act of 1916, as amended, or the Revenue Act of 1917, it appears that an amount of income, war-profits, or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits, or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer."

This provision is supplemental to certain provisions of the Revised Statutes[27] indicating the policy of Congress regarding refunds. Under the provision just quoted the amount of tax erroneously collected on an income return under the Act of

[25] A. R. M. 46, T. B. 19-20-924.

[26] Revenue Act of 1921, § 252; Revenue Act of 1918, § 252. Under this provision munitions tax overpayments for one year may not be credited against an additional assessment of munitions taxes for a subsequent or prior year, or against additional assessments of income, excess-profits and war-profits taxes for the same or for any subsequent or prior taxable year (A. R. M. 123, T. B. 18-21-1613). The tax imposed on *undistributed* net income of corporations by the Revenue Act of September 8, 1916, as amended, is held to be an income tax, and may be credited against an additional amount of income due from the taxpayer (O. 974, T. B. 1-20-662).

[27] R. S., § 3220, as amended by § 1315 of the Revenue Act of 1921; 3221; 3228, as amended by § 1316 of the Revenue Act of 1921.

August 5, 1909, the Act of October 3, 1913, the Revenue Act of 1916, the Revenue Act of 1916, as amended by the Revenue Act of 1917, or the Revenue Act of 1918 may, at any time within five years from the time the return was due, be credited against the tax due on any other income return under those Acts whether or not the taxpayer makes a claim for the credit, and the balance of the excessive amount so erroneously collected over and above the amount so credited may be refunded, whether or not a claim for the same is made.[28]

An assessment made upon an erroneous theory or by mistake will not be remitted or abated because so made, if, at the time its validity is passed on the Commissioner is in the possession of evidence which shows an equivalent amount of tax due in connection with the income, transaction or matter upon which the assessment is predicated.[29]

REVIEW OF COMMISSIONER'S DECISION. Where the Commissioner, in a case within the scope of his authority and jurisdiction, has ordered an abatement, credit or refund, a court can not inquire as to the sufficiency of the evidence before him,[30] and neither the comptroller of the treasury nor any accounting officer has authority to review the Commissioner's decision.[31] Decisions by the Commissioner, in cases where a refund is directed, are binding and, in the absence of fraud, or mistake of calculation, not subject to revision.[32] The Commissioner's decision is conclusive as to the questions of fact.[33] His decisions are in the nature of awards made by arbitrators, and generally speaking bind both the claimant and the government. Prior to the enactment of the provision of the present law discussed below, refund might be impeached for fraud, want of jurisdiction, mistake apparent in the certificate, or for such irregularities as would avoid an award.[34] The Commissioner might reconsider and revoke an allowance for refund at any time before the allowance was paid, but whether a Commissioner might revoke an allowance made by his predecessor was not clear.[35] Where

[28] Sol. Op. 79, T. B. 49-20-1337.

[29] T. D. 3251, T. B. 49-21-1967.

[30] Woolner v. U. S., 13 Ct. Cls. 355.

[31] Bank of Greencastle v. U. S., 15 Ct. Cls. 225. In Sybrandt v. U. S., 19 Ct. Cls. 461, it was held that even three adverse decisions of successive secretaries would not prevent a Commissioner from taking up and allowing a claim for the refund of taxes.

[32] Dugan v. U. S., 34 Ct. Cls. 458.

[33] U. S. v. Wright, 11 Wall. 648.

[34] Dugan v. U. S., 34 Ct. Cls. 458; Cumming v. U. S., 22 Ct. Cls. 344.

[35] Ridgway v. U. S., 18 Ct. Cls. 707.

one Commissioner recommended the allowance of the claim and referred the matter to the secretary for advisement, a succeeding Commissioner to whom the matter was referred back could reject the claim.[36] The Commissioner was not precluded from allowing a claim for refund because a former Commissioner had rejected a claim for abatement, and he was authorized to reconsider and allow a claim which he had, through error of law, previously rejected.[37] No equity powers were conferred on the Commissioner, and the Commissioner was authorized, not obliged, to refund.[38] The uncertainties and doubts bearing upon the finality of decisions as to abatement, credit and refund have been considerably clarified by a provision of the present law that if after determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty or accepted any abatement, credit or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner with the approval of the secretary, such determination and assessment will be final and conclusive (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment made.) Such a case may not be reopened, or the determination and assessment modified, by any officer, employee or agent of the United States, and no suit, action or proceeding to annul, modify or set aside such determination or assessment will be entertained by any United States court.[39]

Procedure for Handling Abatement, Credit or Refund Claims, Effective December 16, 1921. For the more expeditious handling of refund, credit, and abatement claims, and to provide for the refund or credit of overpayments where no claims have been filed, the following procedure has been established to become effective December 16, 1921:

1. Reduction of assessments and adjustments of overpayments will be accomplished in one of three ways:

   (a) On the basis of an application submitted by a taxpayer on Form 46, 47 or 47A, together with appropriate supporting evidence to be filed in the office of the collector of the district in which the tax is assessed.

   (b) On the basis of a certificate of overassessment prepared by the appropriate administrative unit in the bureau

[36] Stotesbury v. U. S., 23 Ct. Cls. 285.

[37] 14 Op. Atty. Gen. 615.

[38] 16 Op. Atty. Gen. 667; 13 Op. Atty. Gen. 439.

[39] Revenue Act of 1921, § 1312. See Chapter 35.

in each case in which an overassessment of tax is disclosed through the audit of a return.

(c) On the basis of a blanket claim (Form 751); a schedule of taxes found to be uncollectible (Form 53); or a schedule of duplicate payments and overpayments due to obvious error on all forms of taxable returns (blanket form 47 or 47B) submitted by a collector. Form 751 will be used only in cases where credit balances exist, regardless of the class of return filed.

2. Claims of taxpayers and the items of collectors' blanket claims (if and when found by an administrative unit to be allowable), and certificates of overassessment (upon final approval), and items credited in account 9 (e) will be scheduled on Form 7777 and submitted to the Commissioner for approval. Upon approval by the Commissioner, such schedules will be forwarded to the collectors of the several districts.

3. Upon receipt of such schedules the several collectors will immediately check the items thereon against the accounts of the several taxpayers concerned and determine whether the several amounts of overassessments should be abated, refunded, or credited against assessments remaining unpaid. Only overpayments of income and profits taxes may be credited against unpaid assessments of such taxes. Whenever, on such examination of a taxpayer's account and of the items in account 9 (e), a collector finds an amount of overpayment, he will examine all accounts of the taxpayer for subsequent periods and determine and certify the amount, if any, of such overpayment that should be credited against the taxpayer's account for any subsequent year or years and the amount of such overpayment for which a disbursement check should be issued. He will thereupon make appropriate entries upon all copies of the schedules and upon the assessment list, indicating the application made by him of the several amounts of overassessment and overpayment (whether by abatement or by credit), and the amounts to be refunded; summarize the amounts applied in abatement, the amounts of overpayment and of credit; certify all copies of the schedule; retain one copy; and forward the others to the Commissioner at Washington.

4. The collector will at the same time prepare (in quadruplicate) on Form 7777A a schedule of net refundable amounts for which disbursement checks are to be issued; retain one copy of the schedule for his record; certify the other three copies and forward them together with the copies of the schedules on Form 7777 to the Commissioner at Washington.

5. Upon application of the several amounts of overassessment and overpayment as abatements or credits, and the determination of the amounts to be refunded, the collector will make the appropriate entries upon the certificates of overassessment which will be forwarded to him with the schedules; and transmit appropriate copies of such certificates to the several taxpayers as notification of the action taken by the collector in the way of abatement or credit; provided, however, that in those cases in which any amount of overpayment is to be refunded, the collector shall not send the certificate of overassessment to the taxpayer, but shall make the appropriate entries thereon and forward such certificates of overassessment with the schedule of refundable amounts to the Commissioner at Washington.

6. Upon completion and certification of a schedule, the collector will credit the accounts with the amounts abated and credited and make proper notations of the refunds. The proper account 6 will be credited, and account 18 will be debited with the total amount abated and applied as credits for the reduction of tax liability. Account 9 (e) will be debited with the total amount applied as credits from items in account 9 (e). The procedure as outlined in Section 583 of the Internal Revenue Manual, in cases of this nature, should be carefully followed.

7. Upon receipt of properly certified copies of Form 7777 and 7777A the Commissioner will cause to be made the necessary entries in the control accounts of the bureau of internal revenue, and the necessary allowance documents prepared. Upon receipt of these schedules the accounts unit of the bureau of internal revenue will retain one copy of Form 7777 for its records and forward a copy to the general accounting office of the comptroller-general as a voucher for the collection of accounts of the collector. He will retain one copy of the schedule of refunds Form 7777A for his records; make the necessary entries upon and forward two copies with the allowance documents to the Commissioner for his approval.

8. Upon approval of schedules of refunds Form 7777A the Commissioner will forward such schedules with the allowance documents to the disbursing clerk of the treasury department.

9. Upon receipt of properly approved schedules and allowance documents, the disbursing clerk shall prepare disbursement checks in the amounts of the several net refundable items in favor of the respective taxpayers against whose accounts net refundable amounts shall have been allowed by the Commissioner; forward such checks, together with the certificates of overassessment (which will be transmitted to him) to the re-

spective taxpayers; retain one copy of this schedule for his record; and transmit the other copy to the general accounting office of the comptroller-general as a voucher for his disbursement account.[40]

Procedure for Claiming Refund. The provisions for claiming refund must be strictly complied with.[41] Claim for the refunding of assessed taxes and penalties must be made out upon the form prescribed by the government (Form 46). The burden of proof rests upon the claimant. All the facts relied upon in support of the claim must be clearly set forth, under oath.[42] The practice is to obtain a copy of the form from the collector to whom the tax was paid or the deputy collector of the division of the district within which the claimant resides, prepare the form according to instructions thereon, and file it with the local collector for further action.[43] Collectors and revenue officers are forbidden to prepare affidavits for persons claiming remission of taxes or penalties under the internal revenue law.[44] An appeal for abatement or refund is imperfect if it does not have endorsed thereon the affidavit of the deputy collector and certificate of the collector required by the regulations,[45] but this is a matter of action within the department. A claim should be accompanied by the collector's receipt or the cancelled check showing payment of the tax. The affidavit may be made by an agent of the person assessed, but in such a case a power of attorney must accompany the claim. Warrants in payment of claims allowed will be drawn in the names of the persons entitled to the money and will, unless otherwise directed, be sent directly to the proper persons or their duly authorized attorneys or agents. In certain cases of overpayment by taxpayers the collector may repay the excess after allowance by the Commissioner of a claim for refund, made by the collector on Form 751. The cases in which refund is made through collectors are covered by specific provisions and discussed elsewhere.[46] The Commissioner has no authority to re-

[40] T. D. 3260. As to the necessity of filing a claim for credit or refund as a prerequisite to suit, see p. 934.

[41] Public Service Ry. Co. v. Herold, 219 Fed. 301; Public Service Gas Co. v. Herold, 227 Fed. 496, 229 Fed. 902.

[42] Reg. 45, Art. 1036, as amended by T. D. 2871. The form to be used in claiming refund is officially known as Form 46.

[43] O. D. 927, T. B. 21-21-1654. See letter of treasury department dated March 29, 1919; I. T. S. 1921, ¶ 2407, as to forwarding claims directly to the Commissioner.

[44] T. D. 2443.

[45] Hastings v. Herold, 184 Fed. 759.

[46] See p. 920.

fund on equitable grounds penalties legally collected.[47] Where additional tax liability is discovered on the audit of a taxpayer's return for one year and a refund is found to be due him for a subsequent year, the procedure to be followed is to make an office adjustment to take care of the additional tax and advise the taxpayer to file a claim for refund of the net overpayment. Where additional tax has already been placed on assessment-list, taxpayer will be required to file claim for credit in order to apply against additional tax a corresponding portion of the refund due him.[48]

Powers of Attorney. The department will recognize a general power of attorney as sufficient authority for the filing of more than one claim for refund on behalf of the grantor of such power. However, special powers are required in certain cases. In cases where a number of claims are to be filed under a general power of attorney the original power should be attached to the first claim filed on behalf of the claimant granting the power, and a copy thereof should be annexed to each succeeding claim, special reference being made in each copy to the claim to which the original instrument was attached. The bureau does not require that a power of attorney to file a claim for refund be in any special form. It is merely necessary that the instrument meet the legal requirements of powers of attorney in general.[49]

Procedure by Collectors Upon Receipt of Claims for Refund or Abatement. The treasury department has prescribed the following procedure to be followed by collectors on the receipt of claims for refund or abatement: Claims for refund or for abatement, pertaining to tax returns which have not at the time been posted to an assessment-list, will be numbered to agree with, attached to, and made a part of, the original return so that the total tax as posted on the assessment-list will be the admitted tax liability to the taxpayer. If a taxpayer submits an amended return as a claim either for refund or for abatement before the original return has been listed, such amended return will be numbered to agree with and attached to the original return in the same manner. Similarly, errors or omissions in returns discovered by the collector prior to the posting operate as an amendment to the amount of tax liability shown by the return. In

[47] Reg. 45, Art. 1036; T. D. 2871. In the case of a taxpayer's death, certified copies of the letters of administration or letters testamentary, or other similar evidence, should be annexed to the claim to show the authority of the administrator or executor.

[48] O. D. 867, T. B. 14-21-1555.

[49] O. D. 927, T. B. 21-21-1654.

other words, all amendments or changes either increasing or decreasing the amount of tax liability and whether originated by the taxpayer or by the collector will be reflected on the face of the return itself and the posting to the assessment-list will be of the correct amount. Amended returns showing a reduced tax liability will not be acted upon by collectors if the original return has been previously entered on the assessment-list. All claims pertaining to returns which have been listed for assessment must be submitted on Form 46, if the tax has been paid, or on Form 47, if the tax has not been paid. The following classes of claims may be included on Form 751 (if for refund), or blanket Form 47 (if for abatement). Separate sheets properly designated of Form 751 or blanket Form 47 must be prepared for returns on file in the Commissioner's office and those on file in the collector's office: (a) All claims for refund or abatement pertaining to Form 1040A income returns for the calendar year 1918, or subsequent years. (b) Errors in computation. (These include only mistakes in arithmetic.) (c) Errors in *specific* exemptions on income returns. (These include such items as failure to deduct exemptions for dependents; the $2,000 exemption for corporations, etc.) (d) Payments in excess of the total amount of tax due as shown by the return. (These include such cases as a remittance of $1,500 covering payment of a tax liability of $1,300, etc.) (e) Amount previously paid on submission of a tentative income return in excess of the total tax liability shown by the final return. (f) Duplicate payments or assessments. (g) All claims for refund on account of nonrevenue remittances forwarded to the collector in error and deposited by him. (These include such items as state or municipal taxes sent to the collector and deposited by him as "unidentified," etc. All claims for refund or abatement other than those enumerated above will be forwarded to the Commissioner for settlement. However, *any* claim may be so forwarded whenever the collector does not feel absolutely certain of the law, regulations or precedent involved, or if his disbursing bond is insufficient to enable him to procure an advance on accountable warrant of the requisite amount of funds from which to make payment. Before forwarding claims to the Commissioner for settlement certification must be made on the claim of the account number, the amount of tax originally due, the dates and amounts of all payments or other transactions affecting such amount, and the balance due as shown by the account on the list. All claims of this nature now on file in the collector's office and hereafter as received should be certified and

forwarded immediately. Claims submitted by taxpayers direct to the Commissioner will in future be referred to the collector for this certificate as to the status of the account on the assessment-list. Until so certified by the collector such claims will not be settled.[50]

Claims for Credit of Taxes Erroneously Collected. To obtain the credit mentioned in the preceding paragraph the taxpayer should proceed as follows:

(1) Where the credit demanded is *equal to or less* than any outstanding assessment of tax, a taxpayer desiring to obtain such credit should file with the collector for the district in which his original return was filed a verified claim on Form 47A, containing the following statements: (a) business engaged in by claimant; (b) character of assessment; (c) amount of tax paid and for what taxable year; (d) portion of tax under (c) claimed as a credit; (e) unpaid assessment against which credit is asked and for what taxable year; and (f) all facts regarding the overpayment.

(2) where the amount claimed as a credit is *greater than* the outstanding assessment of tax, a taxpayer desiring to obtain such credit and the refund to which he is entitled should file, in addition to the claim for credit required to be made on Form 47A for the amount of the outstanding assessment, a claim for refund of the overpayment in excess of the credit. This claim for refund may be attached to the claim for credit or it may be separately filed with the Commissioner. All the facts regarding the total overpayment should be stated in the claim for refund and a reference made to such claim in the claim for credit.[51]

Where a corporation filed a return for 1918 with the collector of one district and a return for 1919 with the collector of another district, and subsequently rendered an amended return for 1918, showing less tax liability, together with a claim for credit against the outstanding tax due for 1919, covering the overpayment to the extent shown by the amended return, it should file the amended return with the collector with whom the original return was filed for the year 1918. The claim for credit should be filed with the collector with whom the return for 1919 was filed, who should forward same to the collector with whom the return for 1918 was filed, for a notation thereon of the facts required by the certificate on the reverse side as to the assessment overpaid for 1918. When this has been done, it will be returned by him to the collector with whom the 1919 return was filed, who will make a

[50] T. D. 2871.
[51] Reg. 45, Art. 1034.

notation thereon as to the 1919 assessment to be credited, and forward same to the Commissioner for consideration. In filing the amended return the taxpayer should call attention to the fact that a claim for credit of the overpayment has been filed with the collector with whom the 1919 return was filed, and the collector with whom the claim for credit was filed should be notified that an amended return has been filed.[52]

ACTION ON CLAIMS FOR CREDIT. Upon receipt by the collector of a claim for credit on Form 47A, he will take no action thereon until the following requirements have been met:

(a) The collector must ascertain from the Commissioner whether a claim for refund for the year or years upon which the claim for credit is based, and upon substantially the same ground, has been filed. If no such claim for refund has been filed the collector may, on notice thereof from the Commissioner, accept for filing the taxpayer's claim for credit.

(b) When it is known to the collector that a refund claim of the nature referred to above is on file with the Commissioner, and has not been adjusted, he will not accept the taxpayer's claim for credit for the same year or years until the taxpayer has requested the Commissioner to reject such claim and has been advised by the Commissioner that such claim has been rejected. Claims for refund may not be converted into claims for credit, except in the manner above mentioned. The substitution of a claim for credit for a refund claim will be expedited by making a direct request to Washington.

Upon acceptance for filing of a claim for credit on Form 47A the collector will certify thereon the required information concerning all outstanding assessments and payments covered thereby and will note on his records that a claim for credit has been filed. He will thereupon transmit the claim to the Commissioner. Due notice will be given the collector and the taxpayer of the action taken on the claim. A schedule of credit claims on Form 7220A will be transmitted to the collector once a month and formal credit shall be taken by the collector at that time. If a claim is allowed against additional taxes due for other years, but such other taxes have not yet been assessed, only the amount of the excess of such taxes over the overpayment shall be assessed, or the excess of the overpayment over such taxes due shall be refunded, as the case may be. The effective date of the filing of a claim for credit will be actual date of presentation to the collector. The filing of a claim for credit against the tax due under

[52] O. D. 740, T. B. 48-20-1327.

another return will be subject to the same rules with respect to the addition of interest and penalties as if the taxpayer had filed a claim for abatement of the tax against which credit is desired.

Under no circumstances will a taxpayer be permitted to take credit for an alleged refund due for a prior year on any return filed for a subsequent year without filing a formal claim for credit on Form 47A, under the requirements provided herein. An attempt to take a credit contrary to the instructions herein set forth will not be held to be a due filing of a claim.[53]

Payment Where Claim for Credit Denied. Where a claim for credit is rejected, the tax which is the subject of the claim is chargeable with interest at the rate of one-half of 1% per month from the time the tax was due until the claim is decided adversely to the taxpayer; notice of the adverse decision is sent to the collector who must send to the claimant a notice and demand for payment of the assessment; if the tax is paid within the 10-day period following the sending of the notice the 5% penalty is not collectible, and the only interest collectible is that at the rate of one-half of 1% per month from the time the tax was due until the date of the Commissioner's decision; if the tax is not paid within the 10-day period, 5% penalty attaches in addition to the above interest and also interest at the rate of 1% per month from the date of the adverse decision by the Commissioner to the date of payment.[54]

Refund of Taxes Collected on Second Assessment. As indicated more fully in the preceding paragraphs, a taxpayer has four years after the payment of any tax within which to claim a refund, even though more than five years have elapsed since the return was made.[55] This ruling has special application to taxes collected on a second assessment, perhaps several years after the return was made. When a second assessment is made in case of any list, a statement or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment will not be remitted, nor such taxes collected under such assessment refunded or paid back or recovered by any suit unless it is proved that such list, statement or return was not wilfully false or

[53] Reg. 45, Art. 1035, as amended by T. D. 3154, T. B. 17-21-1601; letter from treasury department dated November 9, 1921; I. T. S. 1921, ¶ 3212. The above treasury decision became effective on April 12, 1921.

[54] Sol. Op. 32, T. B. 31-20-1106. See, however, footnote 83 in Chapter 35.

[55] See O. 833, T. B. 4-19-235; M. 2764, T. B. 20-21-1642.

fraudulent, and did not contain any wilful understatement or undervaluation.[56]

Statute of Limitations.[57] Under the Revenue Act of 1921 there are two statutes of limitation with respect to the refund of taxes by the Commissioner. It is provided in the present law that "no credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer".[58] The Revised Statutes[59] provide as follows: "All claims for the refunding of any internal tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty or sum * * *"

It will be noted that this statutory period of limitation running from the "payment of such tax, penalty or sum" is equivalent, except in length, to the period in effect under the Revised Statutes before their amendment by the 1921 Law, running from the accural of the cause of action.[60] A cause of action *for a refund* accrued upon payment.[61] But the period is now extended from two to four years and the amended four-year period is made retroactive as to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918. The two limitations are expressed negatively; their affirmative implication is that if claims are presented within five years after the making of a return or within four years after the payment of the tax, they are not barred. The five-year period is supplemental to the four-year period and the provision for the five-year period does not take away any right given the taxpayer under the four-year period. Thus, a taxpayer will be permitted to present a claim with regard to assessments made under the Rev-

[56] R. S., § 3225, as amended by the Revenue Act of 1918 and re-enacted without change by § 1323 of the present law. The 1918 amendment combined the former proviso clause of R. S., § 3220 with R. S., § 3225 in its previous form; and also by the insertion of the words "wilful" and "wilfully" was a statutory enactment of Northwestern Ins. Co. v. Fink, 248 Feb. 568. The government withdrew from its position in Camp Bird, Ltd., v. Howbert, 249 Fed. 27, and the case has been dismissed in the Supreme Court.

[57] The statute of limitations upon *claims* for credit or refund must not be confused with the statute upon *suits* to recover taxes. See p. 919.

[58] Revenue Act of 1921, § 252.

[59] § 3228, as amended by the Revenue Act of 1921.

[60] See R. S., § 2238 before amendment by Revenue Act of 1921.

[61] Kings Co. Savings Inst. v. Blair, 116 U. S. 200.

enue Act of 1918, the 1917 Law, and the 1916 Law, at any time within four years after the assessment is paid, even though such period extends beyond five years after the return is made.[62] If at the expiration of five years from the date the return was due, no credit or refund has been allowed by the Commissioner and no claim for either a credit or a refund has been filed by the taxpayer, the taxpayer will be precluded from relief, if more than four years have elapsed since payment of the tax. A claim for abatement does not take the place of a claim for credit or refund; the claims are separate and distinct, and although the result accomplished may be the same upon all these claims, the requirements of the statute are not satisfied by permitting the use of the claims interchangeably. Neither do amended returns take the place of a claim for credit or refund, and if filed unsupported by such claim or claims, are not in themselves sufficient to warrant the crediting or refunding of any taxes after the expiration of the statutory periods. An application for refund, though informal or defective, may, however, be regarded as a claim so far at least as to permit a formal amendment after the statute of limitations has run.[63] In an opinion rendered under the 1918 Law, it has been held that an overpayment made for a year for which the return was due within the five-year period may be applied against an additional tax due from the taxpayer for any assessable or nonassessable year; but an overpayment made for a year for which the return was due before such five-year period begins may not be credited against an additional tax due for any year, unless a claim for credit or refund has been filed within five years from the date the return was due. It was held under the 1918 Law that claims for the refund of taxes pending in the Commissioner's office on February 25, 1919 (the date when the Revenue Act of 1918 was enacted) but not filed within five years from the date the return was due were not allowable.[64] This injustice has now

[62] O. 833, T. B. 4-19-235; M. 2764, T. B. 20-21-1642.

[63] M. 2764, T. B. 20-21-1642; Maryland Casualty Co. v. U. S., 251 U. S. 342.

[64] Sol. Op. 79, T. B. 49-20-1337. This decision was necessary in view of the repeal of § 14 (a) of the Revenue Act of 1916. Where jurisdiction to act upon cases has been conferred by an act of Congress and then that act is repealed, all pending suits under the repealed provision must stop. (Assessor v. Osborne, 9 Wall. 567; S. C. v. Gaillard, 101 U. S. 433; In re Hall, 167 U. S. 38; U. S. v. Kelly, 97 Fed. 460.) As to claims pending on February 24, 1919, but not filed within five years from the date the return was due, it has been recommended that Congress remove the bar of the statute of limitations, which has now been done.

been remedied by a provision of the Revenue Act of 1921 that the five-year statute shall not bar claims for refund filed prior to the passage of the Revenue Act of 1918 under the Revenue Act of 1916, or filed prior to the passage of the Revenue Act of 1921 under the Revenue Act of 1918.[65] The five-year period of limitations does not apply to cases in which upon an examination of any return made under the Revenue Act of 1917, the Revenue Act of 1918, or the Revenue Act of 1921, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years with the result that an amount of tax in excess of that properly due was paid in any previous year or years. In such cases the amount of such excess may be credited or refunded at any time without the filing of any claim therefor.[66]

WHEN A REFUND IS ALLOWED. A refund has been held to be "allowed" when the Commissioner has signed the allowance schedule. The issuance of a warrant by the division of bookkeeping and warrants is not essential.[67]

WHEN A CREDIT IS MADE OR ALLOWED. A statement contained in a letter from the department that a taxpayer is entitled to a credit is clearly not a credit actually made or allowed. Something must be done in a formal way that will amount to a direction to the collector. Prior to such a direction he has nothing to do with the taxpayer's account since it has not assumed the sta-

[65] Revenue Act of 1921, § 252.

[66] Revenue Act of 1921, § 252. See letter from treasury department dated October 9, 1919; I. T. S. 1921, ¶ 2428.

[67] M. 2764, T. B. 20-21-1642. See, however, T. B. 3260. If a revenue agent's report, or a valuation engineer's report determining an overpayment within the five-year period, is not audited until after the five-year period, the auditor is barred from allowing the overpayment as an offset, even though the taxpayer is not in possession of the valuation engineer's finding and in some cases not in possession of the revenue agent's report, and therefore could not have filed claim within the five-year limitation. When an auditor finds an overpayment for 1913 and offsets it in an A-2 letter to the taxpayer, dated February 25, 1919, and thereafter on a reaudit made October 10, 1919, a greater depletion is allowed, the *additional* overpayment determined subsequent to the expiration of the five-year period can neither be refunded nor credited. When a revenue agent's report, dated May 8, 1919, discovers additional tax for 1913 which was assessed and paid in November, 1919, a waiver having been secured, and upon a reaudit additional depletion is allowed making the tax less than that first assessed, the overpayment for 1913, so paid in 1919, can not be refunded or offset against additional tax for subsequent years, even though the original 1913 return reported no tax. But in such case the taxpayer may claim a refund at any time within four years after the tax was paid under R. S. 3228, as amended.

tus of an account stated to him. Such direction by the Commissioner is usually made by formal assessment-list signed by him. When such a formal statement or direction to the collector is signed by the Commissioner and forwarded to the collector, showing the amount of the tax to be collected over and above the credit, the Commissioner has formally made or allowed the *credit*. When this is done the credit has been made or allowed, but prior thereto anything that is done in the way of stating the case by employees of the bureau or in the way of statements to the taxpayer in letters from the department can be nothing more than preliminary to the actual making or allowance of the credit by the Commissioner. Where the collector makes the credit without specific instructions from the Commissioner, the credit is actually made or allowed when the collector so records it, and in such a case subsequent action by the Commissioner in the way of a review of the collector's action would not operate to fix the time when the credit was made or allowed, since in such a case the collector had before him the account of the taxpayer and is charged by law and the regulations to enter the credit.[68]

Credit Equivalent to Payment. The word "paid" as used in the provision[69] regarding credit and refund has been construed in its broader sense as including a credit duly made. Where there has been an overpayment on a return for a certain year, and within five years from the date the return was due the overpayment is credited to taxes due on a return for a subsequent year, such credit constitutes payment or part payment of taxes for the year in which it was applied. Where a claim for refund is filed for an overpayment on a return, to which a credit has been previously applied because of a supposed underpayment, the return should be adjusted for the year in which the credit was applied. The fact that no record of a credit appears on the assessment-list for the year in which it was made does not affect its validity if it was in fact made within the statutory period.[70]

Suits to Recover Taxes. If a claim is rejected by the Commissioner, a judicial remedy is given the taxpayer by an action against the collector or the United States. If the claim is allowed by the Commissioner and payment refused by the accounting officers, a suit may be brought directly against the government in the court of claims.[71] The allowance of the claim by the Com-

68 Sol. Op. 106, T. B. 23-21-1678. See, however, T. D. 3260.

69 Revenue Act of 1921, § 252; Revenue Act of 1918, § 252.

70 Sol. Op. 107, T. B. 25-21-1697. See, however, T. D. 3260.

71 Edison Electric Co. v. U. S., 38 Ct. Cls. 208. The court of claims has jurisdiction over "all claims except for pensions, founded upon the Consti-

missioner is similar to an account stated between private parties and may be used as the basis of an action against the United States in the court of claims, when payment is not made by reason of the refusal of any of the officers of the department to pass or to pay the claim, and it will be *prima facie* evidence of the amount that is due, and puts on the government the burden of showing fraud or mistake.[72] The district courts of the United States have original jurisdiction of all cases arising under any law providing for internal revenue, or from revenue from imports or tonnage, except those cases arising under any law providing revenue from imports jurisdiction of which has been conferred upon the court of customs appeals.[73] The district courts also had original jurisdiction prior to the Revenue Act of 1921, concurrent with the court of claims, of all claims not exceeding $10,000 founded upon the Constitution, or any law of Congress, or any regulation of an executive department, or upon any contract, express or implied, with the government, or for damages, liquidated or unliquidated, in cases not sounding in tort in respect to which claims the party would be entitled to redress against the United States, either in a court of law, equity or admiralty, if the United States were suable; and of all set-offs, counterclaims, claims for damages, whether liquidated or unliquidated, or other demands whatsoever on the part of the government against any claimant against the government in such court.[74] Such suits are tried by the court without a jury. They were required to be brought (except in the case of certain married women, minors and incompetents) within six months after the cause of action accrued, but this limitation does not seem to bear upon suits to recover overpayments of taxes or penalties.[75] By the Revenue Act of 1921 district courts are given original jurisdiction concurrent with the court of claims, of any suit or

tution of the United States, or any law of Congress * * * in respect of which the party would be entitled to redress against the United States, either in a court of law, equity or admiralty if the United States were suable." (Judicial Code, § 145, 36 St. at L. 1087.)

[72] U. S. v. Savings Bank, 104 U. S. 728; Kaufman v. U. S., 96 U. S. 567; Christie-Street Commission Co. v. U. S., 136 Fed. 326.

[73] Judicial Code, § 24 (5). This jurisdiction is irrespective of the citizenship of the parties (Philadelphia v. Collector, 5 Wall. 720; Schneider v. Barney, Fed. Cas. No. 12,462).

[74] Judicial Code, § 24 (20). There are certain exceptions to this rule, such as claims arising out of the civil war, claims rejected prior to 1887, pensions, and cases bearing upon compensation of officers of the United States.

[75] See R. S., §§ 3227, 3228, and Revenue Act of 1921, §§ 1318, 1319.

proceeding, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal revenue taxes alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected, under the internal revenue laws, even if the claim exceeds $10,000, if the collector by whom such tax, penalty, or sum was collected is dead at the time such suit or proceeding is commenced."[76]

Where an illegal tax is paid, the fact that it was not paid within the time allowed by law will not prevent the taxpayer from recovering a penalty paid by him for the nonpayment of the illegal tax, for, if the tax was illegal, it was never due, and therefore the penalty was as much unauthorized as the tax itself.[77] A person can not recover taxes paid which were in fact due, even though the manner of their assessment or collection was unauthorized.[78]

PREREQUISITES TO SUIT: STATUTE OF LIMITATIONS. No suit or proceeding can be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Commissioner. If the Commissioner's decision on a claim for credit or refund is delayed more than six months from the date of filing, suit may be brought without first securing the decision of the Commissioner. Otherwise, the Commissioner's decision is a prerequisite to suit.[79]

[76] Revenue Act of 1921, § 1310 (c).

[77] Camp Bird, Ltd., v. Howbert, 262 Fed. 114.

[78] Shafer v. Craft, 144 Fed. 907.

[79] R. S. 3226, as amended by § 1318 of the Revenue Act of 1921. In its amended form this section does not affect any suit or proceeding instituted prior to the passage of the 1921 Law (November 23, 1921) but applies to all suits and proceedings instituted after such passage. As the provision stood before its amendment by the 1921 Law, the prerequisite to suit was an appeal to the Commissioner. In view of this provision, it does not seem that the taxpayer would be safe in relying upon the procedure now adopted by T. D. 3260 (see p. 920.) In order to establish a basis for recovery in the courts it is necessary to file a claim for credit or refund, although the department now pays and credits claims without any formal filing. See Rock Island, etc. Rd. Co. v. U. S., 254 U. S. 141, in which this prerequisite to suit is strictly construed (see page 915 above).

STATUTE OF LIMITATIONS UPON SUITS TO RECOVER TAXES. The Revenue Act of 1921 provides a new statute of limitations with respect to suits or proceedings for the collection of taxes alleged to have been erroneously or illegally assessed or collected. Prior to the re-enactment of the 1921 Law it had been provided that no such suit or proceeding could be maintained in any court unless brought "within two years next after the cause of action accrued".[80] If, however, a claim for refund had been filed, the period of limitations would not expire until two years after the Commissioner had denied the claim. The accrual of the cause of action for purposes of a suit against the government or a collector was the date when the Commissioner decided adversely to the taxpayer; that is, the claimant may await the decision of the Commissioner, and if it is adverse, might bring suit within two years thereafter. But he was not required to await such adverse decision; he might at his election bring suit at any time after the expiration of six months from the filing of his claim for refund, if no decision had been rendered by the Commissioner.[81] For example, if a tax was paid on June 28, 1919, the claim for refund was required to be filed on or before June 28, 1921.[82] If the claim is filed on June 28, 1921, the taxpayer might commence his action on December 29, 1921, if no decision had been rendered by the Commissioner. If, however, an adverse decision was rendered by the Commissioner on September 21, 1921, the taxpayer might at once institute action but had until September 21, 1923, in which to do so. The rejection of a claim by the Commissioner must be on the merits and not for irregularity in the form in order to support an action.[83] If an imperfect claim was filed within two years, it was apparently within the statute, although the corrected application was not made within that time, and if suit was brought within two years after rejec-

80 R. S. 3227, now repealed by Revenue Act of 1921; Maryland Casualty Co. v. U. S., 251 U. S. 342.

81 New York Mail and Transportation Co. v. Anderson, 234 Fed. 590; State Line & S. R. Co. v. Davis, 228 Fed. 246; Merck v. Treat, 174 Fed. 388; Farrell v. U. S., 167 Fed. 639; Christie-Street Commission Co. v. U. S., 136 Fed. 326; Hicks v. James' Administratrix, 48 Fed. 542, affirmed 110 U. S. 272; Cheatham v. U. S., 92 U. S. 85; Kings Co. Inst. v. Blair, 116 U. S. 200. It has been held that the cause of action for purposes of an action against the collector accrued six months after claimant had filed a claim for refund and that the claimant had two years *from that date* within which to bring suit. (Schwarzchild & Sulzberger v. Rucker, 143 Fed. 656.) This seems to be the view of the treasury department. See Reg. 45, Art. 1037.

82 New York Mail and Transportation Co. v. Anderson, 234 Fed. 590.

83 Hicks v. James' Administratrix, 48 Fed. 542, affirmed 110 U. S. 272.

tion of the corrected claim, it was within the statute, although more than two years had expired since the first rejection. If the application for refund was filed more than two years after paying the tax, suit could not be maintained, and the fact that the Commissioner rendered an adverse decision on the application, when filed, did not operate to extend the time.[84]

It was thought that the above rule did not provide a definite time within which suits or proceedings might be begun, since the rule made the limitation depend upon the filing of a claim for refund rather than on the payment of tax.[85] For this reason the statute of limitations upon suits or proceedings for the recovery of any tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, may not be begun under the Revenue Act of 1921 before the expiration of six months from the time of filing of a claim therefor with the Commissioner, unless the Commissioner renders a decision within that time, nor after the expiration of five years "from the date of the payment of such tax, penalty or sum."[86] This extension of the period of limitation from two years next after the cause of action accrued to five years from the date of payment does not affect any suit or proceeding instituted prior to the passage of the Revenue Act of 1921, but applies to all suits and proceedings instituted after such passage, whether or not barred by prior acts of congress.[87]

PROTEST AND DURESS. In order to maintain an action for the recovery of taxes it is necessary that the tax shall have been paid under protest and duress.[88]

SUIT AGAINST COLLECTORS. The collector who exacted the tax may be sued for the recovery thereof, but an action thereon cannot be commenced against his successor in office. The remedy lies in an action against the collector to whom the tax was paid,

[84] P. S. Ry. Co. v. Herold, 219 Fed. 301.

[85] Report of Senate Finance Committee on Internal Revenue Bill of 1921, p. 32.

[86] R. S. 3226, as amended by § 1318 of the Revenue Act of 1921. § 1319 of the Revenue Act of 1921 repeals, except as to suits or proceedings instituted prior to the passage of the Revenue Act of 1921, § 3227 of the Revised Statutes which provided for a limitation upon such suits of two years next after the cause of action accrued.

[87] R. S. 3226, as amended by § 1318 of the Revenue Act of 1921.

[88] P. S. Ry. Co. v. Herold, 219 Fed. 301.

or in an action against the United States.[89] It has been held that an action of *assumpsit* may be maintained against the collector who actually exacted the tax, and such action can be revived against the personal representative of the deceased collector.[90] When once an action has been lawfully commenced against a collector, it does not abate by reason of the expiration of his term, but in such event the court may, under the express provisions of a statute, allow the suit to be maintained against his successor.[91] Suits against collectors are brought on the theory of money had and received and in such suits the plaintiff may recover only such money as he is in equity entitled to, and as defendant is not entitled to retain.[92] Sums due the United States are a valid offset as against amounts found due taxpayers in suits against collectors, though included therein are items which the Commissioner did not claim to be due the United States when considering the return for assessment purposes.[93]

[89] For a discussion of this subject see Chapter 35.

[90] Smietanka v. U. S., decided by U. S. Supreme Court October 24, 1921; Sage v. U. S., 250 U. S. 33; Cinn. Gas & Elec. Co. v. Gilligan, T. B. 29-21-1738; Philadelphia H. and P. R. Co. v. Lederer, 242 Fed. 492; Roberts v. Lowe, 236 Fed. 604. In the latter case the court said the latter remedy was apparently authorized by the case of U. S. v. Emery, 237 U. S. 28. As to suing a collector personally under a state law for damages in wrongfully collecting taxes, see P. S. Ry. Co. v. Herold, 229 Fed. 902, 910; Patton v. Brady, Executrix, 184 U. S. 608; Smietanka v. Indiana Steel Co., 42 Sup. Ct. Rep. 1; Sage v. U. S., 250 U. S. 33, T. B. 29-21-1738.

[91] Act of February 8, 1899; 30 Stat. L. 822, c. 121; Smietanka v. U. S., decided by U. S. Supreme Court October 24, 1921; Sage v. U. S., 250 U. S. 33; Cinn. Gas & Elec. Co. v. Gilligan, T. B. 29-21-1738.

[92] N. Y. Life Ins. Co. v. Anderson, 257 Fed. 576. This case has been reversed on another point (see 263 Fed. 527). For a history of the equitable action of assumpsit for money had and received see McKyring v. Bull, 16 N. Y. 297, and Cary v. Curtis, 3 How. 236 (dissenting opinion by Story, J.). In the latter case the dissenting opinion of Story, J., was confirmed as a correct expression of the Congressional intent by the explanatory act of Congress of February 26, 1845. (See Arnson v. Murphy, 109 U. S. 238.) The case of International Paper Co. v. Burrill, 260 Fed. 664, which permits an action for recovery of a Massachusetts tax illegally collected against the collector personally, contains a thorough discussion of the subject of actions against collectors and lays down the rule that a void act gives no protection to the collector from such recovery, that the collector is not discharged from responsibility by the fact that he deposits the illegal tax with the treasury of the taxing authority, that the taxing authority may not equip officials with apparent power under unconstitutional statutes to obtain money from taxpayers and to retain such money in its treasury unless the legislature of the taxing power should "mercifully" otherwise decide.

[93] T. D. 2882, T. B. 9-19-347.

SUITS AGAINST THE UNITED STATES. Suit for recovery of taxes alleged to have been wrongfully assessed and collected may be maintained directly against the United States under the so-called Tucker Act.[94] In answer to the question, "Can the plaintiff bring suit to recover taxes, alleged to have been wrongfully assessed and collected under the corporation tax law, directly against the United States under the Tucker Act, other requirements of law having been complied with, or is its remedy against the collector of internal revenue by whom the assessment and collection were made?" it was held that the question was no longer open.[95] The Tucker Act refers to original suits, and does not permit a recovery of demands against the United States on counterclaims.[96]

CLAIMS FOR REFUND OF SUMS RECOVERED BY SUIT. Claims by taxpayers for the amount of a judgment representing taxes or penalties erroneously collected should be made on form 46. The claimant should state the grounds of his claim under oath, giving the names of all the parties to the suit, the cause of action, the date of its commencement, the date of the judgment, the court in which it was recovered, and its amount. To this affidavit there should be annexed a certified copy of the final judgment, a certificate of probable cause, and an itemized bill of the costs paid receipted by the clerk or other proper officer of the court, together with a certified copy of the docket entries of the court in the case, or so much thereof as may be required by the Commissioner. When a recovery is had in any suit or proceeding against a collector or other officer of the revenue for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the government, no execution will issue against such collector or other officer, but the amount so recovered will, upon final judgment, be provided for and paid out of the proper appropriation from the treasury. If the judgment debtor shall have already paid the amount recovered against him, the claim

[94] Judicial Code, § 24, ¶ 20; Ch. 397, 24 Stat. 635 (U. S. Compiled Stats., p. 3635).

[95] Emery, Bird Thayer Realty Co. v. U. S., 198 Fed. 242, citing Christie-Street Commission Co. v. U. S., 136 Fed. 326.

[96] U. S. v. Nipissing Mines Co., 206 Fed. 431.

should be made in his name. There should also be a certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction, with a detail of all items of costs which were paid by the judgment debtor for which he is liable.[97]

Recovery of Interest. It is a well-settled principle that the United States is not liable to pay interest on claims against it, in the absence of express statutory provision to that effect. It has been established as a general rule in the practice of the government that interest is not allowed on claims against it, whether such claims originate in contract or in tort; whether they arise in the ordinary business of administration, or the private acts of relief by congress on special application. The only recognized exceptions are where the government stipulates to pay interest, and where interest is given expressly by an act of Congress, either by the name of interest, or damages. Not only is this the general principle and settled rule of the executive department of the government, but it has been the rule of the legislative department, because congress, though well knowing the rule observed at the treasury, and frequently invited to change it, has refused to pass any general law for the allowance and payment of interest on claims against the government.[98] Where a person accepts from the government without objection a refund of a sum illegally exacted he gives up his right to sue for interest.[99] The ground for refusal to allow interest is the presumption that the government is always ready and willing to pay its ordinary debts. In a case where there had been a delay of thirty years in prosecuting a claim to recover internal revenue taxes, interest was not allowed from the date of payment of the taxes, but was allowed from the time of commencing the suit.[100] The present law contains a provision for the recovery of interest as indicated in the next paragraph.

Interest on Refunds and Judgments Under 1921 Law. Upon the allowance of a claim for the refund of or credit for internal revenue taxes paid, interest is now allowable upon the total amount of such refund or credit at the rate of one-half of one per centum per month to the date of such allowance, as follows: (1) if such amount was paid under a specific protest set-

97 Reg. 45, Arts. 1031, 1038.
98 U. S. v. Bayard, 127 U. S. 251.
99 Stewart v. Barnes, 153 U. S. 456.
100 Burrough v. Abel, 105 Fed. 366.

ting forth in detail the basis of and reasons for such protest, from the time when such tax was paid, or (2) if such amount was not paid under protest, but pursuant to an additional assessment, from the time such additional assessment was paid, or (3) if no protest was made and the tax was not paid pursuant to an additional assessment, from six months after the date of filing of such claim for refund or credit. The term "additional assessment" means a further assessment for a tax of the same character previously paid in part. No interest will be allowed on any claim up to the time of the rendition of judgment by the court of claims, unless upon a contract expressly stipulating for the payment of interest, except that interest may be allowed in any judgment of any court rendered after the passage of the Revenue Act of 1921 against the United States for any internal revenue tax erroneously or illegally assessed or collected, or for any penalty collected without authority or any sum which was excessive or in any manner wrongfully collected, under the internal revenue laws.[101]

RECOVERY AGAINST COLLECTORS. When, however, an illegal tax has been collected, the citizen who has paid it, and has been obliged to bring suit *against the collector*, is entitled to interest in the event of recovery, from the date of the illegal exaction.[102] Where judgment is recovered in an action against a collector, interest may be recovered up to the time final judgment is entered and a certificate from the trial court that there was probable cause for the collection of the tax has been given. Upon giving such certificate the claim becomes one against the United States, stopping the right to further interest, unless a review of the judgment by an appellate court is obtained, in which event the judgment upon the mandate of the appellate court will be treated as a final judgment, to the rendition of which interest will be allowed, unless the plaintiff unduly delays the presentation of his claim.[103] A suit against a collector is a private suit and there is no claim against the government until a certificate

[101] Revenue Act of 1921, § 1324. This provision was inserted for the purpose of "expediting the refund of taxes and compelling the government, in the event that such refund is unnecessarily delayed, to pay interest at the ordinary rate". (Report of Senate Finance Committee on Internal Revenue Bill of 1921, p. 33.)

[102] Erskine v. Van Arsdale, 15 Wall. 75; Old Colony R. Co. v. Gill, 257 Fed. 220; Redfield v. Bartels, 139 U. S. 694; N. Y. Life Ins. Co. v. Anderson, 263 Fed. 527; N. Y. Mail Co. v. Anderson, 234 Fed. 590; Conant v. Kinney, 162 Fed. 581; Park v. Gilligan, Dist. Ct. So. Dist. Ohio; I. T. S. 1921, ¶ 3067.

[103] Klock Produce Co. v. Hartson, 212 Fed. 758.

of probable cause, under the revised statutes,[104] has been obtained from the court, at which time the government assumes a definite liability of the collector, which does not include the payment of interest thereafter; neither is there any further personal liability on the part of the collector. The interest which may be recovered is that put into the judgment before there is any certificate of probable cause, and if none has been put in, the government assumes no part of the liability of the defendant. The liability assumed by the government includes interest and costs forming part of the recovery, but does not include interest after judgment.[105] It has been held that where railroads, seeking to recover internal revenue taxes illegally assessed, delayed in pressing their claims on account of an understanding with the collectors that the claims should await the decision of other pending cases, but it became apparent that the question of interest could not be adjusted, the railroad's conduct did not disentitle them to interest for any lack of diligence in prosecution.[106]

Costs. The revised statutes authorize the Commissioner to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent or inspector in any suit brought against him by reason of anything done in the due performance of his official duty. Under this section costs may be recovered against the collector.[107] Judgment is usually given in the district court for costs and interest.

Claims for Abatement of Uncollectible Taxes. When a tax under the 1918 Law was found to be uncollectible, the collector or deputy collector who made the demand for payment and was conversant with the facts prepared a claim for abatement on form 53. Although credits allowed on account of insolvency or absconding released the collector from the obligation created by his receipt for the amount credited, the obligation to pay still remained upon the person assessed. It was the duty of the collector to use the same diligence to collect a tax after it had been abated as uncollectible as before abatement. Collectors kept a

104 R. S., § 989.

105 White v. Arthur, 10 Fed. 80.

106 Boston & P. R. Corp. v. Gill, 257 Fed. 221.

107 De Bary v. Carter, 102 Fed. 130. However, see Treat v. Farmers Loan and Trust Co., 185 Fed. 760, 763, as to costs in the Supreme Court and Circuit Court of Appeals.

record of all taxes thus credited and of the persons from whom they were due, and enforced payment whenever it was in their power to do so.[108]

Reopening of Cases. Where any case in the bureau of internal revenue has been finally closed after the taxpayer, or other party thereto, has had a hearing or has been afforded by written notice an opportunity to present oral or written arguments or statements of fact in support of his contentions, the case will not be reopened except (1) where a showing is made of new and material facts, accompanied by an explanation, satisfactory to the Commissioner, of the failure to produce such facts prior to the closing of the case, or (2) where the case is materially affected by the change of regulations or by the final decision of another case either by the Commissioner or by a court of competent jurisdiction. The application for reopening a case should be addressed to the Commissioner, should state succinctly the facts and the circumstances upon which the application is based, and must be supported by the affidavit of a person having knowledge of the facts. This rule is not to be construed as modifying the regulations relating to the filing of claims in abatement or claims for refund, nor as denying the right of a taxpayer to a hearing or to an appeal at any stage of his case until the case has been finally closed. After the taxpayer has exhausted his remedies within the bureau, however, and the case has been finally closed, it will be reopened only under the conditions stated above.[110]

[108] Reg. 45, Art. 1033.

[109] R. S., § 3220, as amended by the Revenue Act of 1918, re-enacted by § 1315 of the Revenue Act of 1921, without change. The 1918 amendment extended the provision to assessors, assistant assessors and agents.

[110] T. D. 3240, T. B. 46-21-1927.

CHAPTER 38

EXAMINATION OF TAXPAYERS' BOOKS

The Revenue Act of 1921 and the Revised Statutes contain certain provisions for the examination of taxpayers' books by revenue agents or inspectors, the attendance of witnesses before the Commissioner and the production of books in suits or proceedings arising under the revenue laws which are set forth in the following paragraphs. The Revenue Act of 1921 adds a new provision to guard the taxpayer against unnecessary examinations or investigations.

Examination of Books. For the purpose of ascertaining the correctness of any return or making a return where none has been made, the Commissioner may, by any revenue agent or inspector designated by him for that purpose, examine any books, papers, records or memoranda bearing upon the matters required to be included in the return.[1] A taxpayer is entitled to satisfy himself in a reasonable manner of the official character and authority of any person making request to examine books or accounts of his bank as an official of the internal revenue bureau.[2] Under the present law, no taxpayer may be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account may be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.[3]

Requiring Attendance of Witnesses. For the purpose stated in the previous paragraph the Commissioner may require the attendance of the person rendering a return or of any officer or employee of such person *or the attendance of any other person having knowledge in the premises*[4] and may take his testimony with reference to the matters required to be included in such return. The Commissioner, every collector, deputy collector,

[1] Revenue Act of 1921, § 1308; Revenue Act of 1918, § 1305. In relation to the income tax this provision seems to supplant R. S., § 3173, which as amended, omits the second case "in case of income tax on or before the first day of March in each year, or on or before the last day of the sixty-day period next following the closing date of the fiscal year for which it makes a return of its income" and also omits the phrase "amount of annual income charged with a duty or tax."

[2] O. D. 609, T. B. 30-20-1096.

[3] Revenue Act of 1921, § 1309.

[4] The italicized words would seem to have been inserted to avoid the effect

internal revenue agent, and internal revenue officer assigned to duty under an internal revenue agent is clothed with power to administer oaths to such person or persons as may be required to attend any hearing before him.[5]

Requiring Production of Books. In all suits and proceedings, other than criminal,[6] arising under any of the revenue laws of the United States, the attorney representing the government may, whenever in his belief any business-book, invoice or paper, belonging to or under the control of the defendant or claimant, will tend to prove any allegation made by the United States, make a written motion particularly describing such book, invoice or paper, and setting forth the allegation which he expects to prove; and thereupon the court may, at its discretion, issue a notice to the defendant or claimant to produce the same. Upon failure to do so the allegation stated in the motion is taken as confessed, unless the failure or refusal is explained to the satisfaction of the court.[7] This provision applies to proceedings under the internal revenue laws as well as the customs revenue laws.[8]

Enforcement of Provisions Requiring Examination, Attendance and Production. If any person is summoned to appear, to testify, or to produce books, papers or other data, the United States district court for the district in which such person resides is invested with jurisdiction of appropriate means to compel such attendance, testimony, or production of books, papers or other data, and to make and issue, both in actions at law and suits in equity, such writs, orders, judgments, decrees and process as may be necessary or appropriate for the enforcement of any provisions requiring such attendance, testimony or production, but only at the instance of the United States. Any remedy of application to the district court is in addition to and not ex-

of such decisions as In re Chadwick, 5 Fed. Cas. No. 2,570, 11 Int. Rev. Rec. 126,133, which held under a similar statute that the books which the assessor has the right to examine are those of the person whose assessment is in question and not those of third persons who have had dealings with him, and consequently that a corporation was not bound to produce its books upon an inquiry into the income of its shareholders.

[5] R. S. 3165, as amended by § 1311 of the Revenue Act of 1921 and by § 1317 of the Revenue Act of 1918.

[6] In Boyd v. U. S., 116 U. S. 616, it was held that proceedings to forfeit a person's goods for an offense against the law, though civil in form, and whether in *rem* or *in personam*, was a "criminal" case, within the meaning of this provision of law.

[7] Act of June 22, 1874, 18 Stat. 187.

[8] U. S. v. Distillery No. 28, 25 Fed. Cas. No. 14,966.

clusive of any and all remedies of the United States in such courts and otherwise to enforce such provisions.[9]

Constitutionality of Statute Providing for Examination and Production of Books. It has been held that (1) the above mentioned provision of law requiring the production of books is unconstitutional and void as to suits for penalties or to establish a forfeiture, because repugnant to the fourth and fifth amendments to the Constitution, which are to be construed in relation to each other; (2) actual entry upon premises and search for and seizure of papers is not required to bring a case within the meaning of the fourth amendment prohibiting unreasonable searches and seizures; (3) a compulsory production of a party's private books and papers to be used against him or his property in a criminal or penal proceeding or proceeding for a forfeiture is within the spirit of such amendment; (4) it is equivalent to compulsory production to make nonproduction a confession of the allegations which it is pretended such books will prove; (5) a proceeding to forfeit goods, though civil in form and whether *in rem* or *in personam*, is a criminal case within the meaning of the fifth amendment which declares that no man "shall be compelled in any criminal case to be a witness against himself;" and (6) the seizure or compulsory production of a man's private papers to be used against him is equivalent to compelling him to be a witness against himself.[10] It is doubtful. however, whether this decision and others of a similar purport[11] relate to proceedings to assess and recover unpaid taxes, or to discover the extent of a person's tax liability, to accomplish which ends the compulsory production of books and papers may be considered a legitimate and appropriate means within the legislative discretion. The constitutionality of a similar statute for the enforcement of the internal revenue laws has been upheld,[12] and it has been asserted that acts conferring the high

[9] Revenue Act of 1921, § 1310; Revenue Act of 1918, § 1318.

[10] Boyd v. U. S., 116 U. S. 616.

[11] Weeks v. U. S., 232 U. S. 383; In re Pacific Railway Comm., 32 Fed. 241.

[12] In re Strouse, 23 Fed. Cas. No. 13,548; 1 Sawy. 605; 11 Int. Rev. Rec. 182. In re Platt, 19 Fed. Cas. No. 11,212, a distinction is pointed out between the constitutionality of an act and the constitutionality of the manner in which the act is administered in any particular case, as follows: "A search and seizure may be unreasonably conducted, in execution, under the statute authorizing it, and thus the right of security sought to be protected by the fourth amendment may be violated; and, under what is due process of law, as authorized by the statute, a person may be deprived of his property, when the statute did not contemplate or authorize such deprivation, and thus the fifth amendment may be violated. But these things are not the

power upon administrative officers of compelling the production of books and attendance of persons have been acquiesced in for so long a time without serious objection that their constitutionality is no longer open to debate.[13] Upon a *habeas corpus* proceeding in the case of a tobacco manufacturer who was committed for failure to appear and produce books in obedience to a summons, it was held that (1) he must bring the books containing the entries relating to his business before the assessor; and (2) he might then be asked to exhibit any entry relating to a particular point and if he should say he could not do so without incriminating himself, he would be protected from exhibiting it.[14] In a later case[15] in the Supreme Court, which sustained the validity of the Interstate Commerce Act so far as it gave power to the Commission to require the attendance of witnesses and the production of papers, it was held that it was open to each witness to contend that he was protected by the constitution from answering the questions propounded to him, that he was not legally bound to produce the books or papers, and that neither the questions propounded nor the books called for related to the matter under investigation. This authority by analogy would seem to dispose of the argument that information brought out in a proceeding under the internal revenue laws to ascertain the amount of tax liability of any taxpayer might be used against him in a later criminal proceeding or proceeding for a penalty or forfeiture. While a witness being examined *de bene esse* under Section 863 of the revised statutes may be compelled to produce books and papers which would be material evidence for the party calling him upon the trial of the case, he

fault of the statute as it stands. They grow out of the fact that the statute is administered, in the particular case, in a manner not authorized by the statute. They are violative alike of the statute and of the Constitution, but they have no effect to make the statute unconstitutional."

13 Perry v. Newsome, 19 Fed. Cas. No. 11,009; 10 Int. Rev. Rec. 20.

14 In re Lippman, 3 Ben. 95; 15 Fed. Cas. No. 8,382; 9 Int. Rev. Rec. 1. This case arose under § 14 of the Act of June 30, 1864.

15 Interstate Commerce Commission v. Brimson, 154 U. S. 447; 155 U. S. 3. This argument is disposed of in another manner In re Phillips, 19 Fed. Cas. No. 11097; 10 Int. Rev. Rec. 107. The court makes the following quotation from Peo. v. Hackley, 24 N. Y. 83: "But neither the law nor the Constitution is so sedulous to screen the guilty as the argument supposes. If a man can not give evidence upon the trial of another person without disclosing circumstances which will make his own guilt apparent, or at least capable of proof, though his account of the transaction should never be used as evidence, it is the misfortune of his condition and not any want of humanity in the law."

may not be compelled to produce his books and papers merely for the purpose of refreshing his memory.[16] The cases upon this point are in some confusion and the distinction between criminal or quasi-criminal proceedings involving penalties and forfeitures and proceedings to ascertain and recover the amount of any tax due, is nowhere clearly drawn.

Corporations. It will be noted that in so far as the above mentioned provisions relating to the examination of witnesses and the production of books and papers have been or may still be declared void, their unconstitutionality is based upon a violation of the fourth and fifth amendments to the Constitution of the United States. It is by no means definitely settled to what extent corporations, which are creatures of the state, are protected and given immunity by virtue of such amendments. In a comparatively recent case in the Supreme Court[17] it was held that corporations were not protected by the fifth amendment and that while an individual may lawfully refuse to answer incriminating questions unless protected by an immunity statute, it does not follow that a corporation vested with special privileges and franchises may refuse to produce its books and papers, but the court expressly stated that it did not wish to be understood as holding that a corporation is not entitled to immunity under the fourth amendment against unreasonable searches and seizures.

National Banks. The law under which national banks are incorporated, which provides for the occasional examination of

16 U. S. v. Tilden, 28 Fed. Cas. No. 16,522; 10 Ben. 566; 25 Int. Rev. Rec. 352.

17 Hale v. Henkel, 201 U. S. 43; Nelson v. U. S., 201 U. S. 92. The court was considerably divided in this case. The opinion of the majority was delivered by Mr. Justice Brown. Mr. Justice Harlan delivered a separate concurring opinion in which he went further than the majority and stated his opinion that a corporation could not claim immunity under the fourth amendment for the reason that it is not a part of the "people" or embraced by the word "persons" as used in that amendment. Mr. Justice McKenna, also concurring, stated his opinion that corporations had no immunity under the fourth amendment, because as stated in Boyd v. U. S., 116 U. S. 616, the fourth and fifth amendments were complimentary of each other and the denial of the protection of one carried a denial of the protection of the other. Mr. Justice Brewer, with whom the Chief Justice concurred, dissented, and stated their opinion that the immunities and protection of the fourth and fifth amendments are available to corporations so far as in the nature of things they are applicable. In International Mining Co. v. Pennsylvania Railroad Co., 152 Fed. 557, Judge Holland, in holding that a corporation may not refuse to produce its books in an action against it to recover damages or penalties for a violation of the Interstate Commerce Commission Act, expresses the opinion that the question had been practically disposed of by the Henkel case.

their affairs and reports of their condition to the national government and enacts that they shall not be subject to any visitorial powers other than are authorized by the act or are vested in the courts of justice, does not exempt them from liability to examination.[18]

Examination of Books and Papers in the Cases of Special Taxes and Other Cases. In the case of any special tax and in the case of other[19] taxes it is the duty of any person, partnership, firm, association or corporation liable to make a verified return to the collector where the articles or objects or goods, wares or merchandise charged with the tax are located. In case of failure to make such return, if the person liable consents to disclose the particulars, it is the duty of the collector or deputy collector to make the list or return which, when consented to, is received as the return of such person. If any person, on being notified or required to make his return by the leaving at his place of residence or business with someone of suitable age or discretion or the depositing in the nearest post-office a memorandum addressed to him, refuses or neglects to make the return within ten days from the date of the notice, or delivers any return, which in the opinion of the collector is erroneous, false or fraudulent or contains any under-valuation or under-statement or refuses to allow a regularly authorized government officer to examine his or its books, the collector may summon such person, partnership, firm, association or corporation or any person having possession, custody or care of the books of account containing entries relating to the business of such person, partnership, firm, association or corporation, or any other person, to appear before him and produce the books and give testimony or answer interrogatories respecting any objects liable to tax or the returns thereof. When the person intended to be summoned does not reside in the state or territory in which the collector's district lies, the collector may enter any collection district where the person may be found and there make the above examination.[20]

Inspection of Government Contracts. The Revenue Act of 1918 provided that every person who on or after April 6, 1917, entered into any contract, undertaking, or agreement with the United States or with any department, bureau, officer, commis-

18 U. S. v. Rhawn, 27 Fed. Cas. No. 16,150.

19 See note 1.

20 R. S., § 3173, as amended by Revenue Act of 1921, § 1311, and by Revenue Act of 1918, § 1317. See Reg. 33, Art. 186.

sion, board, or agency under the United States or acting in its behalf, or with any other person having contract relations with the United States, for the performance of any work or the supplying of any materials or property for the use of or for the account of the United States, is required, within thirty days after a request of the Commissioner therefor, to file with the Commissioner a true and correct copy of every such contract, undertaking, or agreement. Failure to comply with such requests of the Commissioner is punishable as a misdemeanor and by a fine of not more than $1,000, or by imprisonment for not more than one year, or both. The Commissioner (when not violative of the technical military or naval secrets of the government) has access to all information and data relating to any such contract, undertaking or agreement, in the possession, control or custody of any department, bureau, board, agency, officer or commission of the United States and may call upon any such department, bureau, board, agency, officer or commission for a full statement and description of any allowance for amortization, obsolescence, depreciation or loss, or of any valuation, appraisal, adjustment or final settlement, made in pursuance of any such contract, undertaking, or agreement.[21] The above provision is omitted from the present law.

Instructions to Revenue Agents. The following instructions have been given by the treasury department to revenue agents and examiners: "In conducting their examination the agents will, except in clear cases of misrepresentation, proceed on the assumption that all errors in the returns rendered are unintentional; and they will, so far as possible, make their examination in such manner as not to interfere with the company's business, either as to the use of its books or in the general conduct of its affairs. Contentions with officers, employees or representatives of corporations are to be carefully avoided, and no action that may cause friction, that is not necessary in the proper performance of their duties, must be indulged in by officers making these examinations. Ordinarily no very extended examination of the company's books will be necessary, as the verification of the particular items to which attention has been called will be sufficient. Where, however, a thorough examination is found to be necessary, and the accounts are so kept as to involve much labor in their examination, the agent may assign two assistants for this purpose. Where discrepancies between the company's books and the return made are discovered, the officers of the company

21 Revenue Act of 1918, § 1408.

should be given full opportunity to explain the same, and to furnish, if so desired, a sworn statement in reference thereto. In such cases the agent will, if deemed necessary, require the attendance of any officer or employee of the company, and there examine such officer or employee respecting the matter under investigation. The witnesses in such cases should be duly sworn by the agent, and in case of refusal of any such officer or employee to testify, or in the case of refusal to produce the books or papers called for, the agent will at once report the fact to this office."[22]

[22] T. D. 1617.

CHAPTER 39

INFORMATION AT THE SOURCE

To assist in the administration of the income tax law, certain information is required to be furnished by brokers as to their customers, by corporations as to dividend and interest payments, by first or last banks or collection agencies as to foreign items, and by individuals, partnerships and corporations generally (including lessees or mortgagors of real or personal property, fiduciaries, and employers) as to payments of income to others, in order that the treasury department may have data on which to audit returns of income.[1] The several classes of payments which are required to be reported, and the provisions with respect to each, are discussed in the following paragraphs. The Revenue Act of 1921 makes no change in this regard.

Miscellaneous Income, Gains and Profits. It is provided that payments of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits and income of $1,000 or more must be reported by the payor thereof.[2] "Fixed or determinable gains, profits and income," as used in the law,[3] would seem to include payments of all the kinds expressly enumerated and all payments of a similar nature. In the case of collection at the source payments must be annual or periodical, while in the case of information at the source the law does not contain such a limitation. Hence any payments of the kind described in the law, whether made in isolated cases, or from time to time, must be reported.[4] If the aggregate of several payments made to the same payee equals or exceeds $1,000 in any taxable year, the gross amount should be reported. The payments may be from different forms of income, as for instance, from interest and rent, or interest and salary. In such cases, it seems the total is required by law to be reported, if the aggregate of all payments in the year to the same payee equals or exceeds $1,000.

1 Revenue Act of 1921, §§ 254, 255 and 256; Revenue Act of 1918, §§ 254, 255 and 256. These administrative provisions first appeared in the 1916 Law by amendment in 1917.

2 Revenue Act of 1921, § 256; Revenue Act of 1918, § 256. There must be payment. Interest accrued on bank deposits before it has passed to the credit of the depositor need not be reported. (T. D. 2670).

3 Revenue Act of 1921, § 256; Revenue Act of 1918, § 256.

4 Reg. 45, Art. 1071. Payments made to corporations, associations, and insurance companies for the year 1917 did not require reporting.

SALARIES, WAGES OR COMPENSATION. The names of all employees to whom payments exceeding $1,000 a year are made, whether such total sum is made up of wages, salaries, commissions or compensation in any other form, must be reported. A domestic corporation employing American citizens in Canada on a commission basis, and paying such commissions weekly in Canadian money, should compute each commission separately in accordance with the rate of exchange in effect on the date of each payment and report the aggregate amount paid during the taxable year.[5] Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. In the case of an employer having a large number of employees who are moved from place to place as the exigencies of the service require, and who consequently has no complete record of annual payments to them at any one place, the salary of two representative months may be taken to establish a fair monthly wage, and unless the yearly payment based on this estimate in the case of an employee amounts to $1,000 or more, no return of payments to such employee is required.[6] When living quarters such as camps are furnished for the convenience of the employer, the ratable cost need not be added to the cash compensation of the employee in determining whether it equals $1,000 annually. But where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax, and a return of information is required in such case where the cash compensation received plus the value of living quarters furnished equals $1,000 for the year.[7] The value to a domestic servant of the board and lodging received as part of his compensation for services rendered is deemed to be the same amount which he would be required to pay for board and lodging elsewhere than in his employer's household.[8] Bills paid to employees for board and lodg-

[5] O. D. 1066, T. B. 42-21-1870.

[6] Reg. 45, Art. 1072.

[7] T. D. 2670; Reg. 33 Rev., Art. 34; letter from treasury department dated October 25, 1917; I. T. S. 1921, ¶ 1912. See Reg. 45, Art. 33.

[8] O. D. 874, T. B. 15-21-1566. The value of the board and lodging should be entered separately on Form 1099, as evidence of the fact that such value has been considered in computing the total amount received by the servant.

ing while traveling under orders or when the employee is employed on a salary basis, are not part of the employee's salary.[9] Commissions paid to soliciting agents for personal services in securing insurance contracts must be reported at the source, but if the agent conducts a branch office or is employed by the company under a contract that makes it necessary to bear the expenses of the branch office and all payments received are intended to cover such expenses, they need not be reported.[10] Fees paid by a corporation for professional services should be included in a return of information when the amount paid to any individual or partnership during the calendar year equals or exceeds $1,000.[11] In executing Form 1099 an employer who is required to withhold the tax from an employee under a state income tax law should report the amount of the salary paid to the employee plus the amount of tax withheld. The employee should report the same amount in his return.[12]

Where a business which had been operated as a partnership was incorporated in June, 1920, and thereafter operated as a corporation, there being no interruption to the business, and the employees of the partnership being retained by the corporation. it was held that for administrative purposes it will not be considered that there was a change in employer. Since there was no interruption to business, and the employees of the partnership continued to be the employees of the corporation, only one Form 1099 covering the calendar year 1920 was required to be filed in each case where the total amount of payments made equalled or exceeded $1,000.[13]

PAYMENTS WHICH NEED NOT BE REPORTED. Payments of the following character, although over $1,000, need not be reported in returns of information on Form 1099 (revised): (a) Payments of interest on obligations of the United States; (b) dividends paid by domestic or resident foreign corporations (other than distributions by personal service corporations); (c) payments by a broker to his customers; (d) payments made to corporations; (e) bills paid for merchandise, telegrams, telephone, freight, storage and similar charges; (f) payments to employees for board and lodging while traveling in the course of their em-

9 T. D. 2670.

10 Letter from treasury department dated March 28, 1918; I. T. S. 1921, ¶ 1910. See also T. D. 2670 and letter from treasury department dated March 27, 1918; I. T. S. 1919, ¶ 1347.

11 O. D. 416, T. B. 12-20-800.

12 O. D. 401, T. B. 6-20-733.

13 O. D. 788, T. B. 5-21-1422.

ployment;[14] (g) annuities representing the return of capital; (h) payments of rent made to real estate agents (but the agent must report payments to the landlord if they amount to $1,000 or more annually); (i) payments made by branches of business houses located in foreign countries to alien employees serving in foreign countries; (j) payments made by the United States government to sailors and soldiers and to its civilian employees;[15] (k) amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness.[16]

A building and loan association which makes payments to the stockholders equal to the matured value of shares of stock is not required to make a return of information unless the net proceeds or income derived by the stockholder from the transaction amounts to or exceeds $1,000 in any taxable year. The portion of the payment of the matured value of the shares of stock, which represents the purchase price of such shares is merely a return of principal or capital and is held not to be income.[17] Where a lease provides for a payment of rental in crop shares, the landlord and tenant sharing the expenses proportionately, such payments are not fixed or determinable and need not be reported.[18]

Gains and Losses of Customers of Brokers. When directed by the Commissioner, either specially or by general regulation, every person doing business as a broker is required to render a return showing the names and addresses of customers to whom payments were made or for whom business was transacted during the calendar year or other specified period next preceding and giving the other information called for by the form.[19]

[14] This is true notwithstanding the fact that part of such payments may be taxable income to the employee (letter from treasury department dated February 5, 1921; I. T. S. 1921, ¶ 2719).

[15] Reg. 45, Art. 1074.

[16] O. D. 858, T. B. 13-21-1535.

[17] O. D. 759, T. B. 52-20-1364.

[18] O. D. 115, T. B. 2-19-172.

[19] Revenue Act of 1921, § 255; Revenue Act of 1918, § 255; Reg. 45, Art. 1061; Reg. 33 Rev., Art. 33. The 1918 and present law omit the clause of the prior law defining brokers, "on any exchange or board of trade or other similar place of business." It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns. Form No. 1100 is to be used in making such returns.

Dividends on Stock of Taxable Corporations. When directed by the Commissioner, either specially or by general regulation, every domestic or resident corporation and every personal service corporation is required to render a return of its payments of dividends, and distributions to stockholders for such period as may be specified, stating the name and address of each stockholder, the number and class of shares owned by him, the date and amount of each dividend paid him, and when the surplus out of which it was paid was accumulated.[20] It will be noted that foreign corporations may be subject to this duty if they are subject to income tax.[21]

Interest on Obligations of Domestic Corporations. In the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of domestic or resident corporations, the name of the payee is to be reported regardless of the amount of interest paid.[22]

Interest on Obligations of the United States. The law provides[23] that the officers or employees of the United States having information as to payments of interest, etc., and required by regulations authorized by law to make returns in regard thereto, shall render true and accurate returns, under such regulations and in such form and manner and to such extent as may be prescribed by the Commissioner with the approval of the secretary. The department ruled under the 1918 Law, however, that payments of interest on obligations of the United States need not be reported on returns of information.[24]

State and Municipal Bonds. Although interest received from state and municipal bonds is not subject to tax, the law does not expressly exempt such payments from its requirements as to information at the source; neither does it expressly include such payments. No express ruling has been made as to the procedure to be followed in this respect.

[20] Revenue Act of 1921, § 254; Revenue Act of 1918, § 254; Reg. 45, Art. 1051. This section omits the catch-all phrase in modification of payments of dividends—"Whether made in cash, or its equivalent, or in stock." See, however, the definition of the term "dividend" in Revenue Act of 1918, § 200, and in Revenue Act of 1921, § 201. It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns. Form No. 1097 is to be used in making such returns.

[21] See Chapter 12. See also telegram from treasury department dated October 14, 1918; I. T. S. 1918, ¶ 3642.

[22] Revenue Act of 1921, § 256; Revenue Act of 1918, § 256.

[23] Revenue Act of 1921, § 256; Revenue Act of 1918, § 256.

[24] Reg. 45, Art. 1074.

Return of Information as to Payments to Nonresident Aliens. In the case of payments of annual or periodical income to nonresident alien individuals or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns by withholding agents on Forms 1098 (revised) and 1042 (revised) constituted and were treated as returns of information under the 1918 Law.[25]

Foreign Items. The following regulations have been issued under the 1918 Law in regard to foreign items.[26]

SOURCE OF INFORMATION AS TO FOREIGN ITEMS. The term "foreign item," as here used, means any dividend upon the stock of a nonresident foreign corporation or any item of interest upon the bonds of foreign countries or nonresident foreign corporations, whether or not such dividend or interest is paid in the United States or by check drawn on a domestic bank. Wherever a foreign country or nonresident foreign corporation issuing bonds has appointed a paying agent in this country, charged with the duty of paying the interest upon such bonds, such paying agent shall be the source of information. If such foreign country or foreign corporation has no such agent, then the last bank or collecting agent in this country shall be the source of information. In the case of dividends on the stock of a nonresident foreign corporation, however, the first bank or collecting agent accepting such item for collection shall be the source of information.[27]

OWNERSHIP CERTIFICATES FOR FOREIGN ITEMS. When bonds of foreign countries, or bonds or stocks of nonresident foreign corporations, are owned by citizens or residents of the United States, individual or fiduciary, by domestic or resident foreign corporations, or partnerships, or by personal-service corporations, ownership certificate Form 1001a (revised) should be executed by the actual owner or by his duly authorized agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a fiscal agent or a paying agent in this country and issuing bonds which contain a tax-free covenant clause. In such a case the fiscal agent or paying agent is required to withhold the normal tax of 2% from the interest on such bonds and ownership certificate Form 1000 (revised)

[25] Reg. 45, Art. 1076.

[26] See T. D. 2759, amending Reg. 33 Rev., Art. 35, and T. D. 2716 for the rule under the 1916 Law.

[27] Reg. 45, Art. 1077.

modified to show the name and address of the fiscal agent or the paying agent, should be used, unless the owner (if so entitled) desires to claim exemption, in which case Form 1001a (revised) should be filed. When such foreign bonds or stocks are owned by nonresident alien individuals, corporations, or partnerships, ownership certificate Form 1001a (revised) should be used on behalf of such owners by any responsible bank or banker, either foreign or domestic, having knowledge of such ownership. In such a case the bank or banker need not fill in the names of the owners.[28]

Nonresident alien individuals, partnerships, and corporations should file Form 1001a properly modified, in connection with interest coupons on bonds of a corporation organized in the United States but which transacts no business in the United States and owns no property therein.[29]

In cases where a foreign corporation is the registered owner of stock of a domestic corporation and the actual owner is a nonresident alien individual or partnership, disclosure of actual ownership should be made on Form 1087 (revised) in order that a domestic corporation required to render a return of information as to dividends may have at its disposal information as to actual ownership of the stock. The foreign corporation as the registered holder is not, however, required to render any return or withhold any tax from income paid to the actual owner of the stock, nor is there any provision under the law, whereby any withholding of tax at the source is required by the debtor corporation with respect to such income whether actually owned by the registered owner or by a third party.[30]

Where an individual, a resident of this country, is entitled to the interest accruing on some German war loan securities which are held for him by a German bank which institution has requested a domestic bank to transmit the amount to the individual, by drawing a check or draft upon the foreign bank, it is held that an ownership certificate is not required until the foreign item is actually collected, either by the cashing or the depositing of the check and no responsibility with respect to requiring an ownership certificate attaches to the domestic banking institution in connection with this transaction unless the individual presents the foreign item to it for collection. When

[28] Reg. 45, Art. 1078, as amended by T. D. 3031. For a full discussion of the subject of ownership certificates see Chapter 40.

[29] O. D. 354, T. B. 31-19-653.

[30] O. D. 162, T. B. 5-19-263.

the foreign item is collected the amount should be reported on ownership certificate, Form 1001a (revised) in the equivalent of United States money values, according to the rate of exchange in effect at the time collection is made. The check or draft drawn by the domestic banking institution on the foreign banking institution should bear a notation as to what the payment represents, in order that the first bank making payment of such amount may be enabled to identify the check as a foreign item.[31]

FOREIGN ITEMS PRESENTED FOR COLLECTION UNACCOMPANIED BY OWNERSHIP CERTIFICATES. If the foreign item is an interest coupon detached from bonds containing a tax free covenant clause, issued by a foreign country or corporation having a paying agent in the United States an affidavit and ownership certificate, Form 1000 (revised), should be furnished.[32]

In the case of other foreign items which are received unaccompanied by an ownership certificate and the owner is unknown, an affidavit is required of the payee, showing the name and address of the payee, the name and address of the debtor organization, the date of the dividend check or the maturity of the interest coupon, the name and address of the person from whom the dividend check or interest coupon was received, and a statement that the owner of the securities is unknown to the payee. The first bank receiving such foreign item should prepare a certificate of ownership, Form 1001a (revised), crossing out the word "owner" and substituting therefor the word "payee." The first bank should stamp or write across the face of the certificate "affidavit furnished," adding the name of the bank. Thereupon the affidavit and certificate should be forwarded to the Commissioner.[33]

RETURN OF INFORMATION AS TO FOREIGN ITEMS. In the case of collections of foreign items, regardless of amount, the original ownership certificates, when duly filed, will constitute and be treated as returns of information. (a) In the case of dividends, as to which the first bank or collecting agent is the source of information, it shall detach the ownership certificate and indorse on the item the words, "Certificate detached and information furnished," adding its name and address. When foreign items have been indorsed as above prescribed, the certificates must be forwarded to the Commissioner (sorting division) on or before the 20th day of the month following that during which the items

[31] O. D. 641, T. B. 34-20-1150.

[32] See Reg. 45, Art. 368.

[33] Reg. 45, Art. 1078 (a), added by T. D. 3030; O. D. 377, T. B. 3-20-694. The affidavit and certificate are forwarded as provided in Article 1079 of Regulations 45.

were accepted, accompanied by a return on Form 1096a showing the number of certificates and the aggregate amount of foreign items disclosed thereon. An annual return on Form 1096b must be forwarded to the Commissioner not later than March 15 of each year, on which shall be given a summary of the monthly returns. (b) In the case of interest items, as to which the paying agent or the last bank or collecting agent in this country is the source of information, the ownership certificate must accompany the coupon to such agent or source of information, who must forward the ownership certificate to the Commissioner in the same manner as above provided with respect to dividend items. Where ownership certificate Form 1000 (revised) is used, a monthly return must be made on Form 1012 (revised) and an annual return on Form 1013 (revised). Forms 1012 (revised) and 1013 (revised), when so used, should be modified to show the name and address of the paying agent. The use of substitute certificates is not permitted in the collection of foreign items.[34] The procedure as set forth above with respect to the return of information regarding the collection of foreign interest items is applicable as well to the interest on foreign *registered* bonds.[35]

LICENSE. The law provides that all individuals, corporations, or partnerships, "undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks or bills of exchange shall obtain a license from the Commissioner, and shall be subject to such regulations enabling the government to obtain the information required (under this title), as the Commissioner, with the approval of the secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both."[36] Foreign items should not be accepted for collection by any bank or collecting agent so licensed unless properly indorsed or accompanied by proper ownership certificates giving all the information called for by such certificate.[37] Application for a license for the collection of foreign items should be made to the collector of the district in which the business is to be carried on. Upon the acceptance of such application the collector will issue to the applicant,

[34] Reg. 45, Art. 1079.
[35] O. D. 675, T. B. 39-20-1216.
[36] Revenue Act of 1921, § 259; Revenue Act of 1918, § 259.
[37] Reg. 45, Art. 1111.

without cost, a license which will continue in force until revoked or cancelled.[38] Where the collector is not sufficiently informed as to the entire responsibility of the applicant, or where in any case he deems it advisable, the Commissioner may, upon recommendation of the collector, require of the applicant a bond in duplicate with satisfactory sureties in a penal sum at least equal to the estimated amount of tax to be withheld by such applicant during any one year; such bond, however, may not be less than $1,000 nor more than $100,000.[39] This bond, if required, must be renewed annually before January 1 of each year.[40] United States bonds or notes may be deposited under the law, in lieu of a bond with sureties.[41]

Procedure in Paying Income. In order that the payor of the income required by the law to be reported may obtain the necessary information, the law expressly provides, except in the case of reports of dividend payments and reports by brokers, that the name and address of the recipient of income shall be furnished upon demand to the individual, corporation, or partnership paying the income.[42] All payors of income should obtain in some form the name and address of the recipient of such payments. When the person receiving a payment falling within the provisions of law for information at the source is not the actual owner of the income received, the name and address of the actual owner must be furnished upon demand of the individual, corporation, or partnership paying the income, and in default of a compliance with such demand the payee becomes liable to a penalty of not more than $1,000, unless the failure to comply is wilful, in which event the payee will be guilty of a misdemeanor and will be fined not more than $10,000, or imprisoned for not longer than one year, or both, together with the costs of prosecution.[43] The law imposes no duty, however, upon the payor of the income to inquire upon his own initiative as to the ownership thereof, and it would seem that such payor is fully

38 T. D. 2759. Application for such license is made on Form 1017. A license is issued on Form 1010.

39 Reg. 33, Art. 56, January 5, 1914. No bond is required in connection with the issuance of Form 1010, license to collect foreign items, if the collector is satisfied as to the responsibility of the applicant for the license. (O. D. 653, T. B. 35-20-1176.)

40 T. D. 1909.

41 Revenue Act of 1921, § 1329.

42 Revenue Act of 1921, § 256; Revenue Act of 1918, § 256.

43 Reg. 45, Art. 1080; Reg. 33 Rev., Art. 36. See also Revenue Act of 1921, § 253; Revenue Act of 1918, § 253.

protected by reporting in good faith the name and address of the one to whom the income is paid.

Returns of Information at the Source. Returns of information at the source must be made as indicated in the following paragraphs.

MISCELLANEOUS INCOME, GAINS AND PROFITS. All persons making payment to another person of fixed or determinable income of $1,000 or more in a taxable year must render a return thereof to the Commissioner (sorting division) for the preceding calendar year on or before March 15 of each year. The return must be made in each case on Form 1099 (revised), accompanied by a letter of transmittal on Form 1096 (revised) showing the number of returns filed and the aggregate amount represented by the payments. The street and number where the recipient of the payment lives and whether he is single, married or head of a family should be stated, if possible. Where no present address is available, the last known post-office address must be given.[44]

RETURN OF INFORMATION BY PARTNERSHIPS, PERSONAL SERVICE CORPORATIONS AND FIDUCIARIES. Partnerships and personal service corporations are required to prepare reports on Form 1099 (revised) for each member of the partnership or personal service corporation, and fiduciaries must prepare such reports for each beneficiary of the estate or trust, showing in every case the distributive shares of the members or beneficiaries, whether or not actually distributed. If the books of account of a partnership, personal service corporation, or fiduciary are kept on the basis of a fiscal year, the returns of information, Form 1099 (revised), showing the distributive shares of the members or beneficiaries must be rendered on a fiscal-year basis. Such returns, accompanied by Form 1096 (revised), must be filed on or before the fifteenth day of the third month following the close of the fiscal year. All other returns of information, Form 1099 (revised), required to be filed by a partnership, personal service cor-

[44] Revenue Act of 1921, § 256; Revenue Act of 1918, § 256; Reg. 45, Art. 1071. In the case of payments to nonresident alien individuals or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns by withholding agents on Forms 1098 (revised) and 1042 (revised) constituted and were treated as returns of information under the 1918 Law. (Reg. 45, Art. 1076.) The law does not require a return of information with respect to the income of nonresident aliens which is not fixed or determinable. If a withholding agent files Forms 1098, revised, and 1042, revised, in connection with payments of annual or periodical income to nonresident alien individuals, it will not be necessary to file Form 1099. (O. D. 673, T. B. 39-20-1215.)

poration, or a fiduciary must be rendered on a calendar-year basis, regardless of the fact that its books of account are kept on a fiscal-year basis. Such returns, accompanied by Form 1096 (revised), must be filed on or before March 15 of the year following that for which the returns are made.[45] The above information must be furnished on Forms 1099, reporting the payments individually, and a summary prepared on Form 1096. These forms should not be attached to and filed with Forms 1041 and 1065, but forwarded direct to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., in time to be received not later than March 15.[46]

Gains and Losses of Customers of Brokers. The law provides that the return to be made by brokers, if required by the Commissioner, shall state the names of customers (and impliedly their addresses) for whom such brokers have transacted any business, with such details as to profits, losses, or other information as the Commissioner may require as to each of such customers.[47] It is ruled that the addresses of customers must be stated in such returns.[48]

Dividends on Stock of Taxable Corporations. With respect to dividend payments of corporations, the law provides that the return to be made by the corporation if required by the Commissioner, shall state the names and addresses of the stockholders, the number of shares owned by each, and the amount of dividends paid to each during the period covered by the report.[49]

[45] Reg. 45, Art. 1073, as amended by T. D. 3210, T. B. 34-21-1785; O. D. 885, T. B. 16-21-1585.

[46] M. 2708, T. B. 8-21-1469.

[47] Revenue Act of 1921, § 255; Revenue Act of 1918, § 255; Reg. 45, Art. 1061. Two forms of return were contemplated for the reporting by brokers of the gains and losses of their customers. One form (Form 1100, never issued) shows the total gains and losses of each customer. The other (Form 1096) is merely a letter of transmittal under oath, to be used in forwarding the several Forms 1100 to the Commissioner.

[48] Reg. 45, Art. 1061.

[49] Revenue Act of 1921, § 254; Revenue Act of 1918, § 254. Two forms of return were contemplated, under the 1918 Law, which contained the same provision for the reporting of dividends paid by taxable corporations. Form 1097 (revised) gives the required information separately with regard to each stockholder, and must, if required, be forwarded to the Commissioner within ten days from the receipt of notice demanding it. Form 1096 (revised) is merely a letter of transmittal under oath, to be used in forwarding the several Forms 1097 to the Commissioner. Reporting at the source by corporations may be required specially or by general regulation (Reg. 45, Art. 1051).

INTEREST ON OBLIGATIONS OF DOMESTIC OR RESIDENT CORPORATIONS. In the case of payments of interest, regardless of amount, upon bonds and similar obligations of domestic or resident foreign corporations, the original ownership certificates, when duly filed, constitute and are treated as returns of information. If a bondholder files no ownership certificate in the case of payments of interest on registered bonds, the withholding agent is required to make out such a certificate in each instance and file it.[50]

Exempt Corporations. Exempt corporations are required to furnish information at the source in the same manner and according to the same rules as taxable corporations.[51]

Affiliated Corporations. Affiliated corporations will not be permitted to file a consolidated return of information at the source. Each corporation must file a separate return of information.[52]

Department of Municipal Government. A department of a municipal government is required to file a return of information, excluding, however, payments made as salary or wages to officials or employees of the state or political subdivision thereof, and payments of interest on obligations of a state or political subdivision thereof.[53]

[50] Reg. 45, Art. 1075. Monthly return is made on Form No. 1012 (revised). See also Reg. 33 Rev., Art. 43; T. D. 2769.

[51] T. D. 2693.

[52] O. D. 469, T. B. 16-20-268.

[53] O. D. 470, T. B. 16-20-869.

CHAPTER 40

COLLECTION OF THE TAX AT THE SOURCE

The Revenue Act of 1921 provides for withholding at the source on payments of fixed or determinable annual or periodical gains, profits, and income, to any nonresident alien individual or partnership composed in whole or in part of nonresident aliens except income received as dividends of the class allowed as a credit against the normal tax by the law, and interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein, at the rate of 8%, except if the income is from bonds and mortgages, deeds of trust, or similar obligations, of a corporation, containing a covenant to pay any portion of the tax for the bondholder, in which case withholding shall be at the rate of 2%.[1] It is also provided that payments of fixed or determinable annual or periodical gains, profits, and income (with the same exceptions), to any foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein shall be withheld at the rate of 12½% (but during the calendar year 1921 at the rate of only 10%) except in cases where the income is from bonds, mortgages, or deeds of trust or other similar obligations of a corporation containing a covenant to pay any portion of the tax for the bondholder, in which case withholding shall be at the rate of 2%.[2] The provision

[1] Revenue Act of 1921, § 221.

[2] Revenue Act of 1921, § 237. The 1913 Law provided for withholding at the source of the normal tax (1%) on payments of fixed or determinable annual or periodical income to individuals, whether citizens, residents or nonresident aliens. (Act of October 3, 1913, § D.) The 1916 Law provided also for withholding at the source of the normal tax (2%) on payments of similar income to individuals. (Revenue Act of 1916, § 9 (b), (c), (d), (e).) But by the amendment of October 3, 1917, the law was changed so as to require withholding only (a) on payments of fixed or determinable annual or periodical income (except dividends) to nonresident aliens at the rate of 2%; (b) on payments of interest upon bonds of domestic or other resident corporations to foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, at the rate of 6%; (c) on payments of dividends of domestic or other resident corporations to foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, at the rate of 2%; (d) at the rate of 2% on payment of interest on bonds, mortgages, deeds of

of the 1921 Law exempting interest on deposits from withholding was not contained in the 1918 Law. Under the Revenue Act of 1918 no withholding was required on payment of fixed or determinable income to partnerships whether resident or nonresident, or whether or not having any nonresident alien members. No withholding is required under either law on payments to citizens or residents, except in case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations, of a corporation containing a covenant to pay the tax, in which case withholding is required at the rate of 2%.[3] In no case is any tax withheld at the source on payments to domestic corporations or to foreign corporations engaged in trade or business within the United States or having an office or place of business in the United States. Personal service corporations may, after receiving notice from the Commissioner that they have been recognized as such, but not before, proceed as though they were partnerships.[4]

Definition. For convenience, certain terms used in this chapter are here defined. A nonresident foreign corporation is one not engaged in trade or business within the United States and not having any office or place of business therein.[5] A foreign corporation not engaged in trade or business within the United States, which has a fiscal agent in the United States, is not a resident corporation.[6] The term "withholding agent" means any person required to deduct and withhold any tax required to be deducted and withheld by the law.[7] A with-

trust and similar obligations, of corporations to individuals, citizens, residents or aliens, if such bonds, mortgages, deeds of trust and similar obligations contained a covenant to pay any portion of the income tax for the bondholder, or to pay the interest without deduction for any tax which the corporation might be required or permitted to pay thereon or to retain therefrom under any law of the United States, and (e) at the rate of 6% where the owner of bonds, mortgages, deeds of trust, or similar obligations, was not known (Revenue Act of 1916, as amended, §§ 9 (b), (c), (g), 13 (e), (f).) The amendment was retroactive to January 1, 1917, and any normal tax withheld from income paid to citizens or residents in 1917, other than interest described in (d) above, was required by the law to be released and paid over to the persons from whose income such tax was withheld. (Revenue Act of 1917, §§ 9 and 1212.)

3 Revenue Act of 1921, § 221; Revenue Act of 1918, § 221; Reg. 45, Art. 361.

4 Letter from treasury department dated November 20, 1919; I. T. S. 1921, ¶ 1848; O. D. 339, T. B. 29-19-628.

5 Revenue Act of 1921, § 237; Revenue Act of 1918, § 237.

6 O. D. 144, T. B. 4-19-225.

7 Revenue Act of 1921, § 200; Revenue Act of 1918, § 200.

holding agent may be a corporation with bonds outstanding, a trustee under a corporate mortgage, or any corporation, partnership or private individual.[8] The term "bond interest" does not include interest payments on ordinary bankable commercial paper of corporations or ordinary promissory notes of corporations not exceeding one year in time.[9] The term "covenant to pay the tax," means a covenant, contract or provision in the bonds, mortgage, deed of trust or other similar obligations of a corporation by which the obligor agrees to pay any portion of the income tax imposed upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.[10]

Appointment of Withholding Agent. A debtor corporation, which has appointed a withholding agent, should file with the collector for the district in which the debtor corporation is located notice of such appointment, giving the name and address of the withholding agent. Only one copy is required and no special form is prescribed.[11]

Fixed or Determinable Annual or Periodical Income. The phrase "fixed or determinable annual or periodical" income expressly includes interest (except interest on deposits as indicated in a preceding paragraph), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, but expressly excludes income received as dividends of the class allowed as a credit against the normal tax. It also expressly excludes interest on bonds, mortgages or similar obligations of corporations containing covenants to pay any portion of the tax.[12] Only (a) fixed or determinable (b) annual or periodical income is subject to withholding. Included in such income, giving an idea of the general character of income intended, the statute specifies interest, rent, salaries, wages, premiums, annuities, compensations, remunerations and emoluments. But other kinds of income may be included. Income is fixed when it is to be paid in amounts definitely pre-determined. On the other hand, it is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically, that is

[8] Reg. 45, Art. 1533.

[9] T. D. 2090; T. B. "B", p. 31.

[10] Revenue Act of 1921, § 221; Revenue Act of 1918, § 221.

[11] O. D. 207, T. B. 19-19-359; T. B. "B", p. 31.

[12] Revenue Act of 1921, § 221; Revenue Act of 1918, § 221.

to say, from time to time, whether or not at regular intervals. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical.[13] In the following paragraph the term is defined in its various aspects.

SALARIES. Per diem salaries paid on a straight basis of compensation for services rendered are fixed or determinable annual or periodical income, unless the employee is required by the terms of his employment or contract to pay therefrom his own traveling and other legitimate expenses incident to the business of his employment.[14] It is held that salaries, wages and commissions, paid by domestic business enterprises to nonresident alien employees for service rendered entirely in a foreign country are not income in the hands of the recipient as from a source within the United States. They are, therefore, not subject to withholding at the source.[15]

PARTNERSHIP SALARIES. Salaries stipulated by contract or articles of agreement between partnership members constitute fixed or determinable and annual or periodical income. But where, by agreement or otherwise, members of a firm are permitted to draw either stated or unstated sums in advance of an annual or periodical determination of partnership profits, no withholding is required, as these sums do not represent fixed or determinable income within the meaning of the law.[16] Withholding seems to be required against nonresident alien partners on payment of the net distributive shares of the income of a partnership although the regulations do not expressly so state.

COMMISSIONS. A salesman working by the month for a commission on sales, which is paid or credited monthly, receives de-

[13] Reg. 45, Art. 362; Revenue Act of 1921, §§ 221, 256; Revenue Act of 1918, §§ 221, 256. Income of farmers, merchants, agents (unless the compensation is in the form of commissions), lawyers (except annual retainers), doctors, authors, inventors, and other professional persons, whose income is irregular or indefinite, is not fixed or determinable and annual or periodical and is not, therefore, subject to withholding. (T. D. 1890; T. D. 2090.) Although payments of income which is not fixed or determinable and annual or periodical are not subject to withholding, a resident in this country having the receipt, control, or custody of such income may be required, *as agent* for the nonresident principal owner, to report the amount of such income and to account for any and all tax, normal and additional thereon. (Reg. 45, Art. 404.) See Chapter 5.

[14] T. D. 2135.

[15] Reg. 45, Art. 92; Reg. 33 Rev., Art. 32.

[16] Memorandum from treasury department, I. T. S. 1917, ¶ 2282. See Reg. 45, Art. 362.

terminable periodical income.[17] A commission paid on account of a single transaction is not fixed or determinable annual or periodical income.[18] Where a corporation engaged in business as ship-chandlers in accordance with the well recognized practice of the trade, in order to secure the trade of certain ships' captains sells bills of goods and supplies to a ship's captain at a marked price, the invoice showing goods sold in this amount, but accepts as payment in full from the ship's captain a smaller amount, the difference between the two amounts being in the nature of discount or commissions and operating to reduce the price of the goods and supplies sold, it is held that the corporation is not the payor of fixed or determinable annual or periodical income.[19]

PROFIT SHARINGS. Payments constituting a share of the profits of the employer are fixed or determinable and annual or periodical income.[20] The share of profits of a foreign corporation under an arrangement with a domestic corporation whereby the latter purchased goods from the former at a minimum price for resale in the United States, the domestic corporation receiving a commission in the event of resale in excess of the minimum price, and the balance of the excess (after the deduction of certain expenses) being divided between the two corporations, represents income from sources within the United States, but is not subject to withholding since it is not fixed or determinable income.[21]

BONUS. A bonus paid in addition to salary is fixed or determinable income,[22] unless it is a mere gift or gratuity.

DIVIDENDS. The withholding of the tax at the source is not required in the case of income received as dividends of the class allowed as a credit against the normal tax in the case of individuals and as a deduction to corporations. Distributions by a personal service corporation, are, however, subject to the deduction of the tax at the source.[23]

INSURANCE. If a nonresident alien beneficiary of an insurance policy is given the option of accepting the principal of the policy or of allowing it to remain with the insurance company, subject

[17] Reg. 45, Art. 362.

[18] O. D. 907, T. B. 19-21-1623.

[19] A. R. R. 265, T. B. 40-20-1225.

[20] T. D. 2090.

[21] O. D. 384, T. B. 4-20-708.

[22] T. D. 2135.

[23] Revenue Act of 1921, §§ 221 and 237; Revenue Act of 1918, §§ 221 and 237; Reg. 45, Arts. 361, 363.

to quarterly installment payments of interest, the installment payments are taxable income and are subject to withholding, but if the beneficiary has no option in the matter and is required to accept the installment payments, the principal being payable to another person at his death, such payments are held to be a part of the proceeds of the policy. Under the latter circumstances it follows that no withholding would be required, since the payments made to the nonresident alien beneficiary would not constitute taxable income.[24]

INTEREST. Interest, as a general rule, is held to be fixed or determinable and annual or periodical income and subject to withholding.[25]

Interest on call loans made by a domestic bank for the account of a foreign bank is subject to withholding. While the actual amount of interest may vary daily on account of the fluctuation of the principal, the rate of interest is fixed and the amount of interest therefore determinable. The total amount of interest credited to the account of the foreign bank during the calendar year is the amount subject to withholding.[26] Profits derived by a nonresident foreign corporation from the purchase and sale through an agent in this country of bank acceptances at a certain rate of discount are based on interest as accrued and such interest, being fixed or determinable income, is subject to withholding.[27] A domestic corporation owning a majority of the stock of a foreign corporation should withhold the tax on interest credited to the latter.[28] Interest on bonds is treated in a subsequent paragraph. The Revenue Act of 1921 provides[29] that interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein shall not be subject to withholding. Any tax withheld since January 1, 1921, on interest on such deposits should be released and credited to such accounts.[30] No such exception appeared in the 1918 Law

[24] O. D. 767, T. B. 1-21-1374.

[25] Letter from treasury department dated April 22, 1919; I. T. S. 1921, ¶ 1755; Telegram from treasury department dated May 23, 1919; I. T. S. 1921, ¶ 1763; Reg. 33, Art. 67.
Reg. 33, Art. 67.

[26] O. D. 549, T. B. 24-20-1007.

[27] O. D. 221, T. B. 11-19-387.

[28] O. D. 330, T. B. 28-19-616.

[29] Revenue Act of 1921, §§ 221 (a) and 237.

[30] Telegram from treasury department dated November 30, 1921; I. T. S. 1921, ¶ 3253.

and banks were required to withhold the tax on interest paid to nonresident alien individuals or nonresident foreign corporations.[31] In many cases the accounts of foreign banks having balances on deposit in domestic banks are at times overdrawn and instead of crediting interest to their accounts the domestic bank is obliged to debit interest for the money temporarily advanced to the foreign bank. In some cases foreign banks have two accounts with domestic banks, one a deposit account, and the other a borrowing account. In such cases domestic banks were required to deduct and withhold the tax from the entire amount of interest credited to foreign banks upon their deposits in the domestic banks regardless of the amount of interest charged the foreign banks on money advanced to them through loans on borrowed accounts or on account of overdrafts or otherwise. However, if the foreign banks rendered returns of their total income from all sources within the United States they might deduct in such returns the interest charged upon the money advanced to them by the domestic banks to the extent allowed by the Revenue Act of 1918.[32] In such cases the foreign bank was required to include in its gross income the entire amount of the income from which the tax was withheld and paid at the source, as well as income from all other sources within the United States, without deduction for the tax so paid, but any tax actually so withheld was to be credited against the total tax as computed in this return. In the event that the amount of tax so paid at the source by the withholding agent was in excess of the total tax liability of the foreign bank a claim for refund might be filed for the amount overpaid.[33]

31 Letter from treasury department dated April 22, 1919; I. T. S. 1921, ¶ 1755. T. D. 2652; letter from treasury department dated February 4, 1918; I. T. S. 1918, ¶ 3077. Although these rulings expressly stated that withholding was required only with respect to interest paid to nonresident aliens, the reason for limiting the rulings to individuals did not exist under the 1918 Law. (Telegram from treasury department dated May 23, 1919; I. T. S. 1921, ¶ 1763.) The long established rule that banks were not required to withhold on interest paid or accruing on deposits (see letter from treasury department dated June 29, 1917; I. T. S. 1918, ¶ 177) was revoked by T. D. 2652. It seems that the word "paid," as used therein, is intended to include interest which is actually paid and also interest that is credited to the account of nonresident alien individuals, that is, deduction was to take place when the interest was placed at the depositor's credit.

32 See Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2.

33 Letter from treasury department dated July 26, 1919; I. T. S. 1921, ¶ 1764.

EQUIPMENT TRUST CERTIFICATES. Where a trust company, a domestic corporation, entered into an agreement with a foreign railway company by which the trust company leased to the railway company certain railroad equipment and rolling stock for a term of years, the privilege being reserved to the lessee at the expiration of the lease and upon meeting all obligations therein stipulated, to purchase the property for a nominal consideration, the trust company at the same time entering into an agreement with another domestic trust company under which the first trust company was constituted trustee for the subscribers obtained by the second trust company to a fund to be used for the purchase of the railroad equipment and rolling stock which was the subject of the rental agreement, the agreement further providing that the first trust company should issue to the subscribers of the fund equipment trust certificates with semi-annual dividend warrants attached payable only out of rentals paid to the trustee under the lease agreement, it has been held that the obligation to pay the principal of the certificates and the semi-annual dividends thereon is that of the first trust company and that the income derived from such certificates should, therefore, be treated as a domestic item. Although the term "dividends" is used, such payments are in reality interest or compensation at a fixed rate payable at a fixed date for money loaned and are not a dividend declared upon the net earnings of the first trust company. Neither the lease, the equipment trust nor the certificates contain a tax-free covenant clause. The dividends should be reported on ownership certificates, Form 1000, revised, or Form 1001, revised, depending upon whether or not the owners of the certificates are nonresident aliens.[34]

MERCANTILE ACCOUNTS CURRENT. Interest accruing on mercantile accounts current for nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens, or nonresident foreign corporations, if the principal amounts so due as well as the interest are at all times subject to call and payable on demand, is fixed or determinable and annual or periodical income and should be deducted at the source.[35]

RACE TRACK WINNINGS. Winnings of horses at a race track credited by the racing association to a nonresident alien owner and trainer of the horses winning such amounts are not fixed

[34] O. D. 689, T. B. 42-20-1249.

[35] Letter from treasury department dated April 22, 1919; I. T. S. 1921, ¶ 1755; see telegram from treasury department dated May 23, 1919; I. T S. 1921, ¶ 1763.

or determinable annual or periodical income and no withholding by the racing association is necessary.[36]

RENT. Rent is fixed or determinable and annual or periodical income subject to withholding, and this is true whether payment is made in cash or in notes.[37] Where permanent improvements are made by a tenant under the terms of a lease the value thereof is considered income to be accounted for by the landlord, but the amount is not fixed or determinable income.[38] Rent paid by domestic business enterprises to nonresident aliens for property located in a foreign country is not subject to tax as income from sources within the United States and is, therefore, not subject to collection at the source.[39]

ROYALTIES. Where royalties or rentals accrue under the terms of a lease or agrement, as for instance, royalties for the right to mine or remove minerals or other natural deposits, the royalties or rentals are not fixed or determinable and annual or periodical income if they represent a partial return of capital originally invested in the lands by the lessor.[40]

PROMISSORY NOTES. When a note is given in payment of fixed or determinable and annual or periodical income the duty of withholding the tax is imposed upon the maker of the note.[41]

EXEMPT INCOME. Although exempt income may be fixed or determinable and annual or periodical, no withholding is required upon the payment thereof.[42] Thus, an annuity paid by a domestic corporation to a nonresident alien individual is not subject to withholding except to the extent that the aggregate amount of the payments to the annuitant exceeds the amount paid to purchase the annuity.[43]

Bond Interest. The rate of tax to be withheld and the duty of withholding upon the payment of bond interest to nonresident aliens, partnerships composed in whole or in part of nonresident alien individuals, and nonresident foreign corporations depends upon whether the bonds upon which the interest is paid contain or do not contain a covenant to pay the tax, and upon whether

[36] S. 975, T. B. 2-19-157.

[37] T. D. 2090.

[38] T. D. 2442. See Chapter 18 as to when such income is to be reported by the landlord.

[39] Reg. 45, Art. 92; Reg. 33 Rev., Art. 32.

[40] Letter from treasury department dated March 10, 1916; I. T. S. 1919, ¶ 571; T. B. R. 29, T. B. 7-19-303.

[41] Reg. 33, Art. 68.

[42] T. D. 1890; O. D. 628, T. B. 33-20-1129.

[43] O. D. 1086, T. B. 44-21-1898.

the owner of the bonds in question is known. The rates of tax and the rules respecting the withholding of interest paid upon both classes of bonds are given in the following paragraphs.

INTEREST UPON BONDS NOT CONTAINING TAX-FREE COVENANT. Interest paid in 1918 and thereafter upon bonds not containing a tax-free covenant is subject to withholding at the rate of 8% in the case of nonresident aliens or partnerships composed in whole or in part of nonresident alien individuals and 10% in the case of nonresident foreign corporations except that for the calendar year 1922 and subsequent years the rate is 12½% in the case of such corporations. No tax was required to be withheld, under the 1918 Law, from such interest when the bonds in question were owned by nonresident foreign partnerships.[44] The tax should be withheld from such interest payments at the rates in force for the year in which payment is actually made, notwithstanding the interest represents income for the year in which the coupons become due and payable. This is true even though interest coupons which have matured but which have not been cashed represent gross income for the year of maturity because the Revenue Act of 1918 provided that the withholding agent must withhold at the rates prescribed by that law in the case of every payment made after February 24, 1919, and the tax was required to be withheld from the whole payment, not merely that part which applied to the period after February 24, 1919. In case an amount of tax is withheld beyond the tax liability of the taxpayer the excess will be refunded upon application.[45] No tax is required to be withheld from payments of interest upon bonds due prior to March 1, 1913, but paid sub-

[44] Letter from treasury department dated April 18, 1919; I. T. S. 1919, ¶ 3318.

[45] Letter from treasury department dated September 23, 1919; I. T. S. 1921, ¶ 1778, modifying letter from treasury department dated September 5, 1919; I. T. S. 1919, ¶ 3551; O. D. 167, T. B. 6-19-277. See also telegram from treasury department dated June 9, 1919; I. T. S. 1919, ¶ 3431; telegram from treasury department dated September 8, 1919; I. T. S. 1921, ¶ 1777. Owing to the German occupation of Belgium during the war and to the general unsettled conditions in different parts of Europe, it was impossible for foreign owners of American securities to deposit coupons for collection when they became due during the years 1915, 1916, 1917 and 1918. Such coupons were presented for collection in large quantities in the year 1919. In such cases the amount of the coupons should have been entered as income on the returns of the various recipients for the years in which coupons matured, but the withholding agent was required to withhold the tax from these coupons at the rate in force at the time of payment. (Letter from treasury department dated September 23, 1919; I. T. S. 1921, ¶ 1778.)

sequently to that date.[46] Bonds not containing a tax-free covenant are not permitted to be considered tax-free bonds at the option of the issuing corporations, and the issuing corporations are prohibited from paying the tax on interest derived from such bonds, when they are owned by citizens or residents of the United States.[47]

In a case in which a company was trustee for the debenture holders of a banking corporation under an agreement whereby the trustee was to hold the collateral deposited to secure payment of the principal of the bonds and interest, the bonds did not contain a tax-free covenant clause. Since the insolvency of the banking corporation in 1914 the trustee was engaged in liquidating the collateral and applying the proceeds in payment of the debentures. The principal of the collateral having proved insufficient to cover the principal of the debentures, a part of the interest collected on the collateral was applied in payment of the debenture principal and the question was presented whether, with respect to payments to nonresident alien bondholders, the tax should be withheld and paid on the collateral interest accepted in part satisfaction of the debt, and whether the trustee should withhold and pay a tax of 8% on the amounts paid during 1920 as arrears of interest. It was held that no tax was due on the interest from the collateral security applied in satisfaction of the debenture principal, but the trustee was required to withhold and pay a tax of 8% on the amounts paid in 1920 to nonresident aliens on account of arrears of interest.[48]

INTEREST UPON BONDS CONTAINING A TAX-FREE COVENANT. In any case where bonds, mortgages, deeds of trust, or other similar obligations of a corporation[49] contain a covenant, contract, or provision by which the obligor agrees to pay any portion of the income tax imposed upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest

[46] Telegram from treasury department dated August 26, 1919; I. T. S. 1919, ¶ 3547.

[47] Telegram from treasury department dated June 2, 1919; I. T. S. 1921, ¶ 1779.

[48] O. D. 624, T. B. 32-20-1120.

[49] These provisions are not applicable to bonds containing a tax-free covenant clause issued by a partnership. No tax is required to be withheld from the interest on bonds issued by an obligor other than a corporation unless the interest is paid to nonresident alien individuals, partnerships composed in whole or in part of nonresident alien individuals or nonresident foreign corporations, in which case the normal tax of 8% or a tax of 10% or 12½%, is required to be withheld. (O. D. 713, T. B. 44-20-1278.)

without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States, the corporation or its withholding agent is required to deduct and withhold a tax equal to 2% of the interest if paid to (a) an individual whether citizen or resident or nonresident alien, (b) a partnership, whether domestic or foreign, resident or nonresident, and (c) a nonresident foreign corporation.[50] In all such cases the tax to be withheld is at the rate of 2% of the interest paid regardless of the status of the payee. Although the law requires the deduction of the tax at higher rates in the case of payments of other income to nonresident aliens, partnerships with nonresident alien members and nonresident foreign corporations, only 2% is withheld and the recipient of the interest is required to account in his personal return for the remainder of the tax that may be due thereon. The corporation is relieved from withholding in the case of interest payments on such bonds only when the citizen or resident entitled to receive such interest files with the withholding agent on or before February 1, of the year following that in which the interest is received, a signed notice in writing claiming the benefit of the personal exemption or credit for dependents specified in the law, or both. In the case of nonresident aliens withholding, under the 1918 Law, was required regardless of whether or not the nonresident alien might in his personal return be allowed to claim the personal exemption.[51] The practical effect of these provisions of the law is that where a corporation has issued bonds containing a covenant to pay the tax, it will be required to go through the motions of withholding 2% on all payments to bondholders other than domestic corporations and resident foreign corporations, unless in the case of citizens or residents a certificate is filed claiming exemption from the tax on such income. No tax will actually be withheld, since the interest will be paid in full under the terms of the covenant, and the corporation will pay a tax equivalent to the amount theoretically withheld. The recipient of the interest will report in his return of income the full amount of the interest received but he will deduct from the amount of tax otherwise payable thereon a sum equal to 2% of the total amount of such interest. The

[50] Revenue Act of 1921, §§ 221 and 237; Revenue Act of 1918, §§ 221 and 237. This provision is inserted in the law for the purpose of shifting the burden of the tax from the bondholder to the debtor corporation, a burden the corporation would generally not be required to assume were it not for the withholding provision.

[51] Revenue Act of 1918, § 221; Reg. 45, Art. 362.

rulings under the 1918 Law also required that he add to his income the amount of the tax so paid for him on the theory that it is additional interest,[52] but the Revenue Act of 1921 specifically provides that it shall not be so included.[53] If a citizen or resident is not subject to the income tax by reason of the personal exemption to which he is entitled, he should file with the debtor corporation on or before February 1, of the year following that in which the interest was paid, a certificate claiming exemption, as otherwise he will subject the paying corporation to the expense of 2% of the amount of the interest paid him, although no tax is due thereon.

Where a domestic corporation issues tax-free bonds which contain an agreement to pay to the bearer at maturity of the coupons the sum of 5 pounds sterling at the London office of a domestic bank, or $24.34 in gold coin of the United States at a bank in the foreign country in which the debtor corporation is engaged in business, and a citizen of Great Britain elects to accept payment in pounds sterling and receives the equivalent of $19.75 according to the rate of exchange upon the date he receives payment in London, it has been ruled that the debtor corporation is required to withhold the normal tax of 2% on the amount of $19.75, if that amount is the equivalent of 5 pounds when actually received by the nonresident alien individual.[54]

Car-Trust Certificates. Car-trust certificates are held to be obligations similar to corporate bonds and mortgages. The trustees are, therefore, required to withhold the tax at the rate of 2% if the certificates contain a covenant, contract, or provision by which the obligor agrees to pay any portion of the income tax imposed upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.[55]

Unknown Owners. Withholding in all cases at the highest applicable rate is required from interest on bonds or other securities where the owner of such securities is unknown to the withholding agent.[56] The "highest applicable rate" is (a) 2%

52 Reg. 45, Art. 31.
53 Revenue Act of 1921, § 234 (a) 3.
54 O. D. 700, T. B. 43-20-1262.
55 Reg. 33 Rev., Art. 188.
56 Reg. 45, Art. 361.

in the case of interest upon bonds or other obligations of domestic or resident foreign corporations containing a tax-free covenant clause, (b) 8% in the case of fixed or determinable annual or periodical income (other than dividends allowed as a credit and interest on corporate bonds containing a tax-free covenant) payable to an unknown owner.[57]

Scrip. Scrip issued by a corporation to bondholders in payment of interest upon its bonds is equivalent to cash and is subject to withholding. When a corporation which defaulted in the payment of bond interest is reorganized and the new corporation issues scrip in exchange for the coupons representing the defaulted interest, ownership certificates are required to be filed by the owners covering the face value of the coupons exchanged, the form of certificate depending upon whether or not the bonds are tax-free and whether or not the owner claims exemption from having tax paid at the source. The withholding requirements of the law are not applicable to the interest paid by the terms of the scrip on the defaulted bond interest, unless the scrip is held by nonresident aliens.[58] Where as a result of the reorganization of a domestic corporation in 1919, bonds and stocks were issued to holders of securities of that corporation, certain of the holders, due to limited participation, receiving scrip certificates, which, when presented with others aggregating a certain amount entitled the holder to a bond of a stated value, together with interest thereon from June, 1919, bonds equal to the aggregate of scrip issued being certified by the trustee under the mortgage and issued to the treasurer of the corporation in trust for the holders of the scrip and the interest coupons of these bonds, which do not contain a tax-free covenant clause, being presented from time to time by the treasurer for payment, accompanied by ownership certificates, Form 1001, revised, he holding the interest so collected in trust to be paid over to the scrip holders; no interest being paid to scrip holders except when in accordance with the above plan they present scrip and receive in exchange a bond together with accrued interest thereon, it has been held that the scrip holders can not

57 Letter from treasury department dated June 2, 1919; I. T. S. 1919, ¶ 3383; letter from treasury department dated April 18, 1919; I. T. S. 1919, ¶ 3318; O. D. 517, T. B. 21-20-956. This ruling seemed to ignore the fact that 10% should have been withheld if the owner is a foreign corporation, which rate might well be taken to be the "highest applicable rate" as to all income subject to withholding, except interest on tax-free covenant bonds.

58 O. D. 279, T. B. 20-19-512; O. D. 562, T. B. 26-20-1032.

be considered owners of the bonds until the bonds are actually delivered in exchange for the scrip. The accrued interest due the scrip holders is, in effect, interest on the scrip and not interest on the bonds; consequently, no ownership certificates are required to be filed by the scrip holders when receiving the accrued interest upon exchanging their scrip for bonds. When bonds are exchanged for scrip held by nonresident alien individuals, partnerships with nonresident alien members or nonresident alien corporations, the normal tax of 8% or 10% or 12½% should be withheld from the accrued interest and returned in the manner prescribed by law.[59]

Against Whom the Tax Is Withheld. Although the foregoing paragraphs indicate the classes of taxpayers against whom a tax is withheld the law will be restated under this heading for the sake of convenient reference.

CITIZENS AND RESIDENTS. No tax is withheld on payments to citizens and residents except in cases where interest is paid upon any bonds, mortgages, deeds of trust, or similar obligations of corporations containing covenants to pay the tax, in which case the tax is required to be withheld at the rate of 2%.

CITIZENS OF UNITED STATES POSSESSIONS. The income of a citizen of a possession of the United States, who is not otherwise a citizen or a resident of the United States, from sources within the United States, is subject to withholding.[60]

NONRESIDENT ALIENS. In the case of payments of interest upon bonds of corporations containing covenants to pay the tax, the tax is withheld at the rate of 2%. In all other cases where payment is made of fixed or determinable annual or periodical income the tax is withheld at the rate of 8%. A withholding agent is not relieved from obligation to pay to the federal government the amount of tax correctly withheld from the income of a nonresident alien by reason of the fact that the nonresident alien has filed a return showing no tax liability.[61] A domestic corporation is not relieved from withholding on royalties paid to a nonresident alien by reason of the fact that the alien has appointed a domestic banker to act as his agent for the purpose of paying his taxes in the United States.[62]

FIDUCIARIES. The tax is withheld on payments of bond interest to fiduciaries who are citizens or residents of the United States and who have an office or place of business therein in the

[59] O. D. 680, T. B. 41-20-1233.
[60] Reg. 45, Art. 1121.
[61] O. D. 985, T. B. 31-21-1756.
[62] O. D. 1087, T. B. 44-21-1899.

same manner and to the same extent as in the case of citizens and residents, whether the fiduciary is an individual or corporation. The tax is withheld on payments to foreign fiduciaries in the same manner and to the same extent as in the case of nonresident aliens whether the fiduciary is an individual or a corporation. Fiduciaries are subject to all the provisions of the law which apply to individuals.[63] Bond interest paid to a nonresident alien fiduciary is subject to withholding even though the beneficiaries of the income are citizens or residents of the United States.[64]

PARTNERSHIPS. On payments to partnerships, whether domestic or foreign, resident or nonresident, of interest upon bonds of corporations containing covenants to pay the tax, the tax is withheld at the rate of 2%. Under the 1918 Law, no tax was withheld on payment of any other form of income,[65] but under the present law withholding is required against partnerships composed in whole or in part of nonresident alien individuals to the same extent as against nonresident alien individuals.[66] Pending the issuance of regulations on this subject income subject to withholding should be withheld when paid to any partnership.[67]

PERSONAL SERVICE CORPORATIONS. Personal service corporations, after receiving notice from the Commissioner that their returns as personal service corporations have been approved, but not before, may for purposes of withholding proceed as partnerships in claiming exemptions and in obtaining the benefit of having the tax paid for them under tax-free covenants.[68]

CORPORATIONS. No tax is withheld in any case on payment of income to domestic corporations or to resident foreign corporations. In the case of nonresident foreign corporations the tax is withheld at the rate of 2% on all payments of interest upon bonds of corporations containing covenants to pay the tax; and at the rate of 10% on all other fixed or determinable annual or periodical income regardless of the fact that the corporation has filed or intends to file a return covering its income from all

63 Revenue Act of 1921, §§ 225 and 221; Revenue Act of 1918, §§ 225 and 221; Reg. 45, Art. 374; O. D. 1085, T. B. 44-21-1897.

64 O. D. 670, T. B. 39-20-1212.

65 Revenue Act of 1918, § 221; Reg. 45, Art. 361.

66 Revenue Act of 1921, § 221.

67 Telegram from treasury department dated December 2, 1921; I. T. S. 1921, ¶ 3254. It would seem, however, that withholding against partnerships is unnecessary if the payor satisfies himself that the partnership has no nonresident alien members.

68 Letter from treasury department dated November 20, 1919; I. T. S. 1921, ¶ 1848.

sources, within the United States.[69] For the calendar year 1922 and subsequent years the rate is 12½%. For the purpose of withholding, a Porto Rican corporation is a foreign corporation.[70]

AGENTS. The fact that an individual, partnership or corporation may have an agent within this country to collect and receive income, does not operate to prevent withholding of the tax on payments of income to such agent in cases where payments direct to the principal would be subject to withholding. The appointment of an agent in this country does not, in itself, establish the residence of the principal in this country, for the purpose of the income tax, nor does such appointment exempt a nonresident foreign corporation from the withholding provisions unless, in addition to the appointment of the agent, the corporation is engaged in business in this country or has an office or place of business herein. The appointment of an agent in this country will exempt a nonresident foreign corporation from the withholding provisions of the statute provided the agent furnishes the person otherwise obliged to withhold with a certificate stating that the foreign corporation has an office or place of business in the United States and that he will make all necessary returns and pay all taxes shown to be due.[71] Agents of nonresident aliens, foreign partnerships or foreign corporations subject to the withholding provision should proceed, in collecting income from their principals, in the same manner as the principals would proceed in acting for themselves.

Who Are Required to Withhold Tax. Under the 1921 Law and the 1918 Law it is required that all individuals, corporations and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income shall withhold the tax, when withholding is required by reason of the status of the recipient of the income.[72] It has been held that a foreign cor-

[69] Revenue Act of 1921, §§ 221 and 237; Revenue Act of 1918, §§ 221 and 237; Reg. 45, Art. 361; O. D. 910, T. B. 19-21-1627; O. D. 858, T. B. 12-21-1523.

[70] Revenue Act of 1921, § 237; Reg. 45, Art. 1133.

[71] O. D. 358, T. B. 1-20-661.

[72] Revenue Act of 1921, §§ 221 and 237; Revenue Act of 1918, §§ 221 and 237.

poration having a fiscal agency in this country is required to withhold a tax of 2% upon the interest upon its tax-free covenant bonds.[73]

DUTY OF EMPLOYER TO DETERMINE STATUS OF ALIEN EMPLOYEES. Employers are responsible for the deduction of the tax at the source on payments of salary or compensation to nonresident alien employees.[74] Aliens employed in the United States are *prima facie* regarded as nonresidents for the purpose of withholding.[75] If wages are paid without withholding the tax, the employer should be provided with written proof of facts which overcome the presumption that the alien is a nonresident.[76] Such presumption may be overcome as outlined in another chapter.[77] The employer may rely upon the evidence of residence afforded by the fact that the alien has filed Form 1078 (revised) or an equivalent certificate establishing residence.[78] A record of such forms of certificates should be kept by every employer and the certificates forwarded to the Commissioner (Sorting Division, Washington, D. C.) not later than the twentieth day of the month succeeding that during which they were

[73] Reg. 45, Art. 361; letters from treasury department dated July 9, 1918; (I. T. S. 1918, ¶ 3612) and July 18, 1918; (I. T. S. 1918, ¶ 3613); O. D. 561, T. B. 26-20-1030.

[74] Letter from treasury department dated May 21, 1919; I. T. S. 1919, ¶ 3394. This was first required in September, 1915. (See T. D. 2242.) Withholding after February 25, 1919, should be at the rate of 8 per cent. Although nonresident aliens were subject to a normal tax of 12 per cent for 1918, only 2 per cent was required to be withheld during that year, the balance due to be accounted for in the individual income tax returns.

[75] Reg. 45, Art. 313, as amended by T. D. 3155, T. B. 17-21-1599.

[76] Reg. 45, Art. 315, as amended by T. D. 3155, T. B. 17-21-1599. See Reg. 45, Art. 316, however.

[77] See Chapter 3.

[78] Reg. 45, Art. 315, as amended by T. D. 3155, T. B. 17-21-1599. If an officer, qualified to administer oaths, is not reasonably accessible, Form 1078 (Revised), will be accepted if signed in the presence of an official of the employer company under whose supervision the employee's duties are performed, and one other credible witness. (Letter from treasury department dated September 20, 1919; I. T. S. 1919, ¶ 3612.) Having secured such evidence from the alien, the employer may rely thereon unless the statement of the alien was false and the employer has reasonable cause to believe it false, and may continue to rely thereon until the alien ceases to be a resident. It is not necessary to secure new certificates for each taxable year. (Letter from treasury department dated July 9, 1919; I. T. S. 1921, ¶ 525. An alien who has established a residence in the United States continues to be a resident until he or his family evidence an intention to change their residence to another country by starting to remove.) (Reg. 45, Art. 314, as amended by T. D. 3155, T. B. 17-21-1599; T. D. 2794.)

received.[79] An employer who seeks to account for failure to withhold the required tax and who did not at the time secure Form 1078 (revised) or its equivalent, is permitted to prove the former status of the alien by any material evidence.[80] The burden of proof in such cases is on the employer and such proof must be in writing. Hence the name and address of employees should be secured, regardless of the fact that for the convenience of the employer the individual is known by number.[81] In the case of alien seamen, the regulations provide that residence may be established on a vessel regularly engaged in coastwise trade.[82] This provision, however, merely places alien seamen employed on a vessel regularly engaged in coastwise trade on the same footing with an alien employed within the United States for purposes of proving residence within the United States. The employer should, therefore, be governed by the above requirements with respect to the necessity for filing Form 1078 (revised).[83]

EMPLOYEES OF MINING CONTRACTORS—"BACK HANDS." It is customary in a great many mining districts to let out a certain portion of a mine to some miner who is usually termed a contractor, who employs additional labor for the production of coal for the section of the mine assigned to him. These men, usually termed "back hands," sometimes do not appear upon the pay-roll and are very frequently not officially known to an operator or employer. The operator frequently does not know the amount of earnings of the "back hand" or laborer employed by the contractor and the latter usually keeps no books of account. In such cases the duty of withholding the tax at the source is that of the contractor and not of the corporation.[84]

CHANGE OF STATUS OF EMPLOYEE. Where the status of an alien changes during the year from that of resident to that of nonresident, or from that of a nonresident to that of resident, the status which exists at the end of the taxable year is the one which determines his right to exemption as to the whole year. Where an employer has withheld wages from a nonresident alien

[79] Letter from treasury department dated May 21, 1919; I. T. S. 1921, ¶ 527; Letter from treasury department dated July 9, 1919; I. T. S. 1919, ¶ 3492; O. D. 143, T. B. 4-19-224.

[80] Reg. 45, Art. 1315, as amended by T. D. 3155, T. B. 17-21-1599.

[81] Reg. 45, Art. 315; T. D. 2794; Letter from treasury department dated May 26, 1919; I. T. S. 1921, ¶ 1740; O. D. 175, T. B. 7-19-298.

[82] Reg. 45, Art. 312.

[83] Letter from treasury department dated September 20, 1919; I. T. S. 1921, ¶¶ 520, 1694.

[84] Letter from treasury department dated May 26, 1919; I. T. S. 1921, ¶ 1740; O. D. 175, T. B. 7-19-298.

during part of the year and thereafter the employee becomes a resident (before the employer has paid over to the United States the amount of tax withheld), the employer is authorized on receiving proof of the change, to refund to the employee the amounts which had been withheld from him during the earlier part of the taxable year, while his status was that of a nonresident. As a condition precedent to a refund an employer should require the employee to return the receipts showing the amount of tax previously withheld before making the refund.[85] If the status of a resident employee changes to that of a nonresident alien, the employer should withhold the tax at the rate of 8% from all wages or compensation paid to such employee on and after the date on which the employer has knowledge of the change. Although an employee in such case will be taxable as a nonresident alien for the entire taxable year during which his status is changed from that of a resident to that of a nonresident alien, the employer will not be held liable for the deduction of the tax with respect to wages paid prior to the knowledge of the employer as to the change in status.[86]

DUTIES OF ASSIGNEES. Where in connection with the sale of its property, payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, corporation, or a state or political subdivision thereof, must deduct and withhold such taxes as would have been required to be withheld by the assignor had no such sale and transfer been made.[87]

Exemption From Withholding. Withholding from interest on bonds or other obligations containing a tax-free covenant will not be required in the case of a citizen or resident alien individual if he files with the withholding agent when presenting interest coupons for payment, or not later than February first following the taxable year, an ownership certificate on Form 1001 (revised) claiming a personal exemption or credit for dependents. To avoid inconvenience a resident alien individual should file a certificate of residence on Form 1078 (revised) with withholding agents, who should forward such certificates to the Commissioner (Sorting Division) with a letter of transmittal.[88] The

[85] O. D. 302, T. B. 24-19-569.

[86] Letter from treasury department dated August 6, 1919; I. T. S. 1921, ¶ 1751; letter from treasury department dated June 12, 1919; I. T. S. 1921, ¶ 1749; O. D. 128, T. B. 3-19-196; O. D. 302, T. B. 24-19-569; O. D. 254, T. B. 15-19-447.

[87] Reg. 45, Art. 364.

[88] Reg. 45, Art. 363.

extent to which nonresident aliens may secure exemption from withholding as against any income from sources within the United States up to the amount of any personal exemption and credit for dependents which may be allowed to them under the similar credit provision of the statute is discussed elsewhere.[89] Tax erroneously withheld from the wages of a nonresident alien seaman who can not now be located for the purpose of making refund should be reported on the annual list return, Form 1042, and paid to the government, and when the seaman is located he should be advised of his right to file claim for refund.[90]

Ownership Certificates. The owners of bonds or other obligations, whether or not containing a tax-free covenant, issued by domestic or resident foreign corporations, when presenting interest coupons for payment, are required to file a certificate of ownership for each issue of bonds, showing the name and address of the debtor corporation, the name and address of the owner of the bonds, the nature of the obligations, the amount of interest and its due date, and the amount of any tax withheld. No ownership certificates need be filed in the case of interest payments on bonds the income from which is not included in gross income, nor in the case of any obligation of the United States.[91] All the information called for by ownership certificates is necessary for the efficient administration of the Revenue Act. Debtor corporations will be held responsible for the proper execution of certificates, but not as to misstatements by bond owners. Ownership certificates should not be accepted and payments should be refused unless all information called for thereon is shown.[92] Ownership certificates executed by the owner must indicate whether or not he is married or the head of a family.[93] But interrogatories as to the marital status on ownership certificates need not be answered when certificates are exempted by nonresident alien individuals.[94] But if he states that he

[89] See Chapter 31.

[90] O. D. 258, T. B. 16-19-463.

[91] Reg. 45, Art. 364. Bonds of the war finance corporation are held not to be government bonds. (O. D. 284, T. B. 21-19-527.) Debentures may be the equivalent of bonds so that ownership certificates are necessary in connection with payments thereon (O. D. 1060, T. B. 41-21-1861).

[92] M. 2725, T. B. 11-21-1514. Telegram from treasury department dated April 7, 1919; I. T. S. 1921, ¶ 1814; telegram from treasury department dated February 28, 1918; I. T. S. 1918, ¶ 3146; O. D. 615, T. B. 31-20-1104.

[93] Letter from treasury department dated March 26, 1918; I. T. S. 1921, ¶ 1824.

[94] Telegram from treasury department dated May 23, 1918; I. T. S. 1918, ¶ 3380.

is married it is not also necessary that he state that he is head of a family.[96] The address may be omitted from ownership certificates in the case of prominent corporations and in its place a description of the bond issue may be inserted.[97] Separate ownership certificates will be required for each interest coupon of different maturity date even though of the same issue.[98] The official position of the person authorized to sign ownership certificates in behalf of a corporation and the identity of the person signing in behalf of a partnership is required to be disclosed on the certificates.[99] Pending a decision by the United States Supreme Court on the taxability of interest on joint-stock land bank bonds, no ownership certificates are required in collecting interest on such bonds.[100] In the case of interest payments on overdue bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.[101]

WHERE CONDITIONS CHANGE BETWEEN INTEREST DATES. Where an interest coupon is presented for payment of interest upon a bond which has been sold between interest dates, the coupon should be accompanied by the ownership certificate of the purchaser only, and the certificate should cover the full amount of the coupon. The purchaser may, if he does not claim exemption from having the tax paid at the source, take credit in his return for the tax paid at the source on the entire amount of interest represented by the coupon. The discrepancy between the amount of bond interest reported in the purchaser's return in such cases, and the amount of interest shown by his ownership certificates to have been collected by him should be explained by a statement attached to and made a part of the return, showing the total amount of interest collected and the

96 Letter from treasury department dated March 30, 1918; I. T. S. 1919, ¶ 671.

97 Telegram from treasury department dated February 11, 1918; I. T. S. 1921, ¶ 1817.

98 Telegram from treasury department dated June 24, 1919; I. T. S. 1921, ¶ 1822.

99 Telegram from treasury department dated June 16, 1921; I. T. S. 1921, ¶ 3065.

100 O. D. 758, T. B. 52-20-1363.

101 O. D. 392. T. B. 5-20-719.

amount of interest accrued on the bond to the date of purchase.[102] Certain bonds contain the privilege of being converted into the stock of the corporation which issued the bonds. If the owner of the bonds exercises his privilege of conversion between interest dates and is allowed accrued interest, he is required to file an ownership certificate covering such accrued interest when it is paid.[103]

FORMS OF OWNERSHIP CERTIFICATES. The following is a list of the latest revisions of ownership certificates:

Form 1000	Revised	January, 1921
" 1001	"	January, 1921
" 1001A	"	January, 1921
" 1058	"	January, 1921
" 1059	"	January, 1921
" 1087	"	April, 1919

Form 1071 is now obsolete, Form 1001A being used in its place.

RULES FOR USE OF FORMS. As a general rule, Form 1000 is used when withholding is required and Form 1001 is used when no withholding is required. Forms 1058 and 1059 are substitute certificates to be used as indicated below in the place of the original ownership certificates which are sent to Washington. Form 1058 is used in lieu of original ownership certificate Form 1001, and Form 1059 is used in lieu of original ownership certificate Form 1000. The use of Form 1087 is indicated in Chapter 5. Form 1001A is used in connection with foreign items, as defined above. The following is a table indicating the particular form of ownership or substitute certificates to be used in particular cases as stated in the text following the table:

[102] O. D. 830, T. B. 9-21-1483; Letter from treasury department dated February 16, 1921; I. T. S. 1921, ¶ 2724, revoking letters from treasury department dated July 21, 1920, and August 17, 1920; I. T. S. 1921, ¶¶ 1880-1893.

[103] O. D. 949, T. B. 24-21-1689.

Table for Use of Ownership and Substitute Certificates.[1]

CLASSIFICATION OF OWNER	OWNERSHIP CERTIFICATES: Bonds of Domestic or Resident Foreign Corporations — With Tax-Free Covenant	OWNERSHIP CERTIFICATES: Bonds of Domestic or Resident Foreign Corporations — Without Tax-Free Covenant	OWNERSHIP CERTIFICATES: Foreign Items[2]	SUBSTITUTE CERTIFICATES: With Tax-Free Covenant	SUBSTITUTE CERTIFICATES: Without Tax-Free Covenant
Citizen or Resident—					
Individual or fiduciary claiming exemption	1001[6]	1001	(1000 or 1001 A)[3]	1058	1058
Individual or fiduciary not claiming exemption	1000		(1000 or 1001 A)[3]	1059	1058
Partnership and Personal Service Corporations[7]	1000	1001	(1000 or 1001 A)[3]	1059	1058
Corporations	1001	1001	(1000 or 1001 A)[3]	1058	1058
Nonresident Alien					
Individual or fiduciary	1000	1000	1001 A	None Permitted	None Permitted
Partnership	1000	1001	1001 A	None Permitted	None Permitted
Corporations[5]	1000[8]	1000	1001 A	None Permitted	None Permitted
Banks receiving coupons not accompanied by Ownership Certificates — Ownership					
Unknown	1000	1000	(1000 or 1001 A)[4]	......	.....
Foreign Governments	1001	1001	(1000 or 1001 A)[9]	......	......
Foreign Charitable or Exempt Corporations	1000	1000	......	......	......

1 See Reg. 45, Arts. 365-7, 1078; letter from treasury department dated May 20, 1919; I. T. S. 1919, ¶ 3338; telegram from treasury department dated July 7, 1919; I. T. S. 1919, ¶ 3474. O. D. 144, T. B. 4-19-225; O. D. 520, T. B. 21-20-958.

2 The term "foreign item", as here used, means any dividend upon the stock of a nonresident foreign corporation or any item of interest upon the bonds of foreign countries or nonresident foreign corporations, whether or not such dividend or interest is paid in the U. S. or by check drawn on a domestic bank. (Reg. 45, Art. 1077.)

3 1000 is used in this instance if the foreign country or foreign corporation has a fiscal agent in this country and if the bonds contain a tax-free covenant clause, unless exemption is claimed. (Reg. 45, Art. 1078; letter from treasury department dated May 20, 1919; I. T. S. 1919, ¶ 3338.)

4 1001 A is used in this instance if the owner is known to be a nonresident alien individual, corporation, or partnership, and in the case of bonds not containing a tax-free covenant and stocks of foreign corporations.

5 A foreign corporation not engaged in trade or business within the U. S., which has a fiscal agent in the U. S., is not a resident corporation. (Letter from treasury department dated May 20, 1919; I. T. S. 1919, ¶ 3338.)

6 In the case of registered bonds having a tax-free covenant 1000 is used by the withholding agent if the owner files no certificate. That is, if the owner files no certificate the withholding agent must presume that he does not claim exemption from withholding. (Reg. 45, Art. 369.)

7 Before a corporation can be regarded as a personal service corporation it must have received notice from the Commissioner that its claim to be regarded as a personal service corporation has been approved. (Letter from treasury department dated November 20, 1919; I. T. S. 1921, ¶ 1848.) Personal service corporations are to be treated, so far as practicable, on the same basis as partnerships. Corporations which have received notice that their returns as personal service corporations have been approved may thereafter, and not before, issue Form 1000 in collecting interest from bonds or other obligations of a corporation containing a so-

called tax-free covenant clause in the same manner and to the same extent that partnerships are authorized to use that form. The form should bear the stamped or written notation "approved by the treasury department as personal service corporation on (date)." (O. D. 339, T. B. 29-19-628.)

[8] A foreign corporation, notwithstanding it claims to be exempt, is required to file Form 1000 (revised) in collecting interest on bonds issued by domestic or resident corporations, and the debtor corporation, or its withholding agent, is required to pay the tax due. Such foreign corporation, however, has the privilege of establishing its exemption. When a debtor corporation has assumed the payment of the 2% normal tax on the interest derived from its tax-free bonds, owned by an exempt foreign corporation, it may file a claim for refund accompanied by the proof of exemption submitted by the foreign corporation. Otherwise, the foreign corporation should file a claim for refund accompanied by the required proof. (O. D. 616, T. B. 31-20-1105.)

[9] Income payable to a foreign government is not subject to tax, but should be reported on line 6 of Form 1001-A, crossing out the word "corporation" and substituting "foreign government". With respect to foreign items presented for collection unaccompanied by an ownership certificate, if the item is a coupon detached from a bond containing a tax-free covenant clause and the debtor organization has a paying agent in the United States, line 6 of Form 1000 is the proper place for reporting such income. (O D. 520, T. B. 21-20-958.)

Form of Certificate Where Withholding Required. Form 1000 (revised) should be used (a) by citizens or residents of the United States when no personal exemption or credit is claimed against interest on bonds containing a tax-free covenant; (b) by nonresident alien individuals and nonresident foreign corporations, whether or not such bonds contain a tax-free covenant; (c) by partnerships, and personal service corporations, resident or nonresident, in the case of bonds containing a tax-free covenant, and (d) where the owner is unknown to the withholding agent.[104] When a debtor corporation fails to withhold the 2% tax where its bonds contain a tax-free clause, and the owner has filed Form 1000, there is no obligation on the bank first receiving the coupons to withhold the tax, as assessment will be made against the debtor or its disbursing agent based on the tax liability as disclosed by Form 1000.[105]

Form of Certificate Where No Withholding Required. Form 1001 (revised) should be used (a) by citizens or residents of the United States when personal exemption is claimed against interest on bonds containing a tax-free covenant and when presenting coupons from bonds not containing a tax-free covenant; (b) by domestic corporations; (c) by partnerships,

[104] Reg. 45, Art. 365.

[105] O. D. 56, T. B. 1-19-76.

resident or nonresident, in the case of bonds not containing a tax-free covenant; and (d) by resident foreign corporations, whether or not such bonds contain a tax-free covenant; and (e) for foreign governments, whether or not the bonds contain a tax-free covenant. In case a citizen or resident alien individual receives interest on bonds containing a tax-free covenant in excess of the amount of personal exemption which the individual may claim, any such excess must be reported on Form 1000 (revised).[106] That is, he cannot claim exemption from withholding with respect to an amount greater than his personal exemption even though he may want to relieve the paying corporation of the contract duty to assume the burden of the tax on his behalf. Where a corporation sets aside certain amounts in a sinking fund under the control of a trustee and such fund is invested by the trustee in whole or in part in bonds, the trustee when presenting coupons from the bonds for payment is required to file ownership certificates, Form 1001, revised, whether or not the bonds contain a tax-free covenant clause.[107]

USE OF SUBSTITUTE CERTIFICATES. Resident collecting agents, responsible banks and bankers, receiving interest coupons for collection with ownership certificates attached, may present the coupons with the original certificates to the debtor corporation or its duly authorized withholding agent for collection or may detach and forward the original certificates direct to the Commissioner, provided each such collecting agent shall substitute for such original certificates its own certificates—Form 1058 (revised) or Form 1059 (revised)—and shall keep a complete record of each transaction, showing (a) serial number of item received; (b) date received; (c) name and address of person from whom received; (d) name of debtor corporation; (e) class of bonds from which coupons were cut (whether containing a tax-free covenant or not); and (f) face amount of coupons.

The original certificate for which the certificate of the collecting agent is substituted should be indorsed, preferably with a rubber stamp, by the collecting agent as follows:

Owner's certificate No.............

....

(Name of collecting agent.)

..........................19....

(Give date of certificate.)

The counterpart of the within certificate bearing like number was attached to the coupons within mentioned for delivery to the debtor or withholding agent, by whom the coupons are payable.

106 Reg. 45, Art. 366.

107 Reg. 45, Art. 541 (a) added by T. D. 3056, T. B. 35-20-1173.

Where substitute certificates are used, the name of the bank or collecting agent may be printed or stamped and the facsimile of the signature of the person authorized to sign the substitute certificate for the bank or collecting agent may also be printed or stamped on the certificate. However, in all cases the bank must first file with the Commissioner of Internal Revenue, sorting division, a certificate of its authorization in substantially the following form:

....
(City.) (Date.)

The Commissioner of Internal Revenue, Washington, D. C.

The undersigned hereby authorizes the use of the facsimile signature shown below upon all substitute income-tax certificates issued in its name until this authorization is revoked by written notice to you.

....
(Name of bank or collecting agent.)

By..................................
(Signature of person authorized to sign.)

....
(Official position.)

....
(Facsimile signature of person authorized to sign.)

As a convenience to banks and trust companies having a large number of ownership certificates to execute in the collection of interest on bonds, it has been provided that the name of the bank or trust company may be printed or stamped and the facsimile of the signature of the person authorized to sign for the bank or trust company in executing the said ownership certificates may be printed or stamped on the certificate; provided that in all cases the bank or trust company shall first file with the Commissioner (sorting division) a certificate of authorization in substantially the following form:[108]

....
(City.) (Date.)

The Commissioner of Internal Revenue, Washington, D. C.:

108 T. B. "B", p. 28.

The undersigned hereby authorizes the use of the facsimile signature shown below upon all income tax ownership certificates issued in its name until authorization is revoked by written notice to you.

. . . .
(Name of bank or trust company.)

By. . . . .
(Sig. of person authorized to sign.)

. . . .
(Official position.)

. . . .
(Facsimile signature of person authorized to sign.)

For the purpose of identification the substitute certificates should be numbered consecutively and corresponding numbers given the original certificates of ownership. The use of substitute certificates by collecting agents, banks and bankers is not permitted, in the case of ownership certificates presented with coupons for collection by nonresident alien individuals, partnerships, or corporations.[109] Substitute certificates may be used in connection with payments of income made to the alien property custodian.[110]

INTEREST COUPONS WITHOUT OWNERSHIP CERTIFICATES. Where interest coupons are received unaccompanied by certificates of ownership the first bank should require of the payee an affidavit showing the name and address of the payee, the name and address of the debtor corporation, the date of the maturity of the interest, the name and address of the person from whom the coupons were received, the amount of the interest, and a statement that the owner of the bonds is unknown to the payee. Such affidavit should be forwarded to the collector with the monthly return on Form 1012 (revised). The first bank receiving such coupons should also prepare a certificate on Form 1000 (revised), crossing out "owner" and inserting "payee" and entering the amount of interest on line six and should stamp or write across the face of the certificate "Affidavit furnished," adding the name of the bank.[111]

109 Reg. 45, Art. 367, as amended by T. D. 2967, T. B. 6-20-732; T. B. "B," p. 28.

110 Letter from treasury department dated June 6, 1918: I. T. S. 1919, ¶ 1522.

111 Reg. 45, Art. 368, as amended by T. D. 3018, T. B. 22-20-973.

In a case in which a foreign bank placed in the mails to be transmitted to an American firm, a package containing coupons clipped from bonds of a domestic corporation, the ship upon which the package was forwarded was sunk by a submarine and the insurance company which had insured the foreign bank against loss paid to it the face value of such coupons. The insurance company filed an indemnity bond, but settlement of the claim for an amount representing the face value of the coupons was deferred by the debtor corporation, pending the receipt by it of an ownership certificate from the insurance company, covering the amount of the claim. It was held that the amount representing the face value of the coupons did not constitute income to the insurance company, but was nevertheless income of the bondholders. The insurance company was required to obtain ownership certificates from the owners of the bonds and forward them to the debtor corporation with the claim. If the bondholders were unknown, the insurance company, as payee, was required to furnish a certificate on Form 1000 (revised).[112] Ownership certificates are required to be filed with respect to interest payments upon first-mortgage participation bonds issued by a trust company and secured by a real estate mortgage deposited with the trustee. In cases where coupons of the bonds are not accompanied by ownership certificates, the first bank is required to furnish a certificate. Where no ownership certificates are filed in connection with interest upon such registered bonds, the withholding agent will be required to prepare certificates.[113]

INTEREST ON REGISTERED BONDS. Where a bondholder files no ownership certificate in the case of payments of interest on registered bonds the withholding agent should make out such a certificate in each instance (a) on Form 1000 (revised) if the bondholder is a citizen or resident of the United States or a resident or nonresident partnership or a personal service corporation and the bonds contain a tax-free covenant, or if the bondholder is a nonresident alien individual or a nonresident foreign corporation, and (b) on Form 1001 (revised) in all

[112] O. D. 633, T. B. 33-20-1136. Since the insurance company paid to the foreign bank the face value of the coupons, without deduction for tax due the United States, the recovery of the excess amount paid was held to be a matter to be adjusted between the insurance company and the bondholders, and between the bondholders and the corporation issuing the bonds.

[113] T. B. "B", p. 31.

other cases. When so used Forms 1000 (revised) and 1001 (revised) need not be signed.[114]

Return of Tax Withheld. Every withholding agent is required to make an annual return to the collector of the tax withheld from interest on corporate bonds or other obligations on or before March 1 on Form 1013 (revised). He is also required to make a monthly return on Form 1012 (revised) on or before the 20th day of the month following that for which the return is made. If there is not sufficient space on Form 1012, it should be continued on Form 1012-A. Remittances frequently accompany this return. This is improper and should be avoided. The original ownership certificates, or the substitute certificates, where authorized, must be forwarded to the collector with the monthly return. Every person required to deduct and withhold any tax from income other than such bond interest must make an annual return thereof to the collector on or before March 1 on Form 1042 (revised), accompanied by a separate report on Form 1098 (revised), for each nonresident alien individual, partnership composed in whole or in part of nonresident alien individuals or nonresident foreign corporation to whom income other than bond interest was paid during the previous taxable year. In every case of both classes the tax withheld must be paid on or before June 15 of each year to the collector.[115]

Release of Excess Tax Withheld. Any sum withheld for tax in excess of the aggregate amount required under the law will be released by the withholding agent and paid over to the person from whom it was withheld or his proper representative. With reference to how a debtor corporation may release and pay over the amount of tax so withheld in a case where a bank or other collection agency detached the ownership certificate which accompanied an interest coupon and substituted its own certificate (Form 1059), which does not disclose the name and address of the bond owner, in such cases the withholding agent should request the bank or collection agency to disclose the name and address of the owner of the bonds, as shown by the original certificate, and it shall be the duty of the bank or collection agency to make such disclosure to the withholding agent. Where withholding agents have so released any excess of tax, an itemized statement showing the names, addresses and amounts refunded should be attached to the annual list returns (Form

[114] Reg. 45, Art. 369.

[115] Reg. 45, Art. 370; T. B. "B", p. 32.

1013), in order to reconcile any discrepancy between the aggregate amount of taxes returned as shown by the monthly list returns (Form 1012) and the aggregate amount as shown by the annual list return.[116]

USE OF INFORMATION RETURN WHERE NO ACTUAL WITHHOLDING. Where a debtor corporation or its duly authorized withholding agent has made payments of interest on its bonds, but in certain instances has been required to withhold no tax, the ownership certificates on Form 1001 (revised) filed in connection with such payments should be transmitted directly to the Commissioner (sorting division), accompanied by a return on Form 1096-A showing the number of ownership certificates thus transmitted and the total amount of interest paid. This return shall be made by the 20th day of each month following that for which the return is made and need not be sworn to. An annual return shall be forwarded to the Commissioner not later than March 15 of each year on Form 1096-B, on which shall be given a summary of the monthly returns. To the extent that there has been actual withholding of the tax, returns should be made.[117]

OWNERSHIP CERTIFICATES IN THE CASE OF FIDUCIARIES AND JOINT OWNERS. When fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. Separate ownership certificates are not required for each beneficiary.[118] When bonds are owned jointly by several persons, a separate ownership certificate must be executed in behalf of each of the owners.[119]

Withholding in the Case of Enemies. Payments made after October 6, 1917, to the Alien Property Custodian are in the same category as payments made to or for citizens or residents of the United States. Withholding at the source is accordingly unnecessary except in the case of interest payments on corporate bonds or other obligations containing a tax-free covenant where

116 Reg. 45, Art. 372. The 2% tax withheld on dividends of domestic corporations in 1918 should be released in this manner. (Letter from treasury department dated March 24, 1919; I. T. S. 1919, ¶ 3283.)

117 Reg. 45, Art. 373. Return is made in this case in accordance with Reg. 45, Art. 370.

118 Reg. 45, Art. 374; letter from treasury department dated November 17, 1921; I. T. S. 1921, ¶ 3223.

119 Reg. 45, Art. 374.

no exemption is claimed. The Alien Property Custodian should use Form 1000 (Revised) in collecting interest on bonds containing a tax-free covenant and in all other cases should use Form 1001 (Revised), except that in cases in which the Alien Property Custodian shall, under the Trading-With-the-Enemy Act, demand payment to himself of interest accrued upon bonds or other securities not yet reduced to his custody (even though they be registered in the name of an enemy, ally of an enemy, or his agent or trustee), the corporation paying such income to the Alien Property Custodian is authorized to accept from the Alien Property Custodian ownership certificates, Forms 1000 (Revised) and 1001 (Revised), altered by the substitution (in lieu of the certificate required thereon) of a certificate that the Alien Property Custodian is entitled to the interest entered therein with or without deduction of tax, as the case may be. No distinction is to be made between payments directly to the Alien Property Custodian and to his depositaries and between interest on registered bonds and interest on coupon bonds. In the case of enemies or allies of enemies holding a license granted under the provisions of the Trading-With-the-Enemy Act, withholding is required as in the case of any nonresident alien not an enemy or ally of enemy.[120] Any tax erroneously withheld after October 6, 1917, will be deemed to have been erroneously withheld, up to the time of restoration of the property to the original owners by the Alien Property Custodian, but, after the restoration of the property, the tax so withheld if otherwise properly withheld in accordance with the Revenue Act of 1916, as amended, if not in excess of the tax liability of such alien will be deemed to have been properly withheld and, if returned and paid to the government as income tax, may be taken as a credit against the tax shown to be due by the return required for the respective year to be submitted at or after the restoration of the property by the Alien Property Custodian.[121]

Return of Income From Which Tax Withheld. The entire amount of the income from which the tax was withheld should be included in gross income without deduction for such payment of the tax. But any tax actually so withheld will be credited against the total tax as computed in the taxpayer's return. If

[120] Reg. 45, Art. 375, as amended by T. D. 2969, T. B. 7-20-742. For the rule with respect to withholding on income paid to or for alien enemies see T. D. 2673. This ruling is not revoked by the attorney-general's opinion of June 21, 1920, published in T. B. 30-20-1092.

[121] O. D. 657, T. B. 36-20-1185.

the tax is paid by the recipient of the income or by the withholding agent it will not be re-collected from the other, regardless of the original liability therefor, and in such event no penalty will be asserted against either person where no fraud or purpose to evade payment is involved.[122] The amount of normal income tax paid at the source by a debtor corporation in behalf of a bondholder may be credited against the total tax due from the bondholder even though he may be liable to surtax only.[123]

[122] Reg. 45, Art. 376.
[123] O. D. 423, T. B. 13-20-812.

CHAPTER 41

COVENANTS TO PAY TAXES

Covenants to pay taxes are contained in bonds, mortgages, notes, leases, and similar instruments whereby it is stipulated, in general, that the debtor, lessee, or other payor shall pay the interest, rent, or other income without deduction for taxes. Many such covenants became operative under the 1913 Law, and the 1916 Law prior to its amendment by the act of October 3, 1917, by reason of the requirement in those laws that the normal tax should be withheld at the source. They operate under the 1916 Law as amended and under the present law and the 1918 Law only in certain cases and to a limited extent. Such covenants for the purpose of this discussion may be divided into two classes: (1) Those which are contained in bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, and (2) those contained in other instruments. Those contained in the second class operate only when the payee is a nonresident alien or a nonresident foreign corporation, unless the covenant is so broad that it imposes an obligation on the payor notwithstanding that the interest, rent, or other payments thereunder are made in full without deduction of any tax at the source. Covenants of the first class stated above may be of two kinds: (a) Those which agree to assume the tax of the payee only to the extent that the interest specified in the obligation shall be paid in full, and (b) covenants which may be so broad in their terms as to obligate the debtor to reimburse the creditor for any tax which may be imposed upon him with respect to the interest after it has been received in full by the creditor. Covenants broad enough to fall within the second class are very unusual and are not covered by the discussion in this chapter. Those covenants to pay the tax which are embraced within the language of the statute[1] and discussed in this chapter are only those which have all the following qualifications: (a) They must be made by corporations; (b) they must be contained in bonds, mortgages, deeds of trust, or other similar obligations, and (c) they must be such as to bind the debtor corporation to pay some portion of the tax imposed by the Revenue Act of 1921 on the creditor, or to reimburse the creditor for any portion of the tax, or to

[1] Revenue Act of 1921, § 221 (b); Revenue Act of 1918, § 221 (b). O. D. 519, T. B. 21-20-957.

pay the interest without deduction for any tax which the debtor may be required or permitted to pay thereon, or to retain therefrom, under any law of the United States. Where payment of interest is made under such covenants a tax equal to 2% of the interest is required to be withheld at the source if the owner of the obligations is (a) an individual, whether he is a citizen or alien, resident or nonresident; (b) a partnership, whether domestic or foreign, resident or nonresident; (c) a nonresident foreign corporation.[2] Withholding at the highest applicable rate is required from interest on bonds or other securities where the owner of such securities is unknown to the withholding agent. The term "highest applicable rate" means 2% in the case of tax-free covenant bonds and 8% in the case of bonds not containing such covenants.[3] The tax is not required to be withheld on payments to domestic corporations or to resident foreign corporations. It is required to be withheld on payments to a fiduciary although the fiduciary may be a corporation. The tax cannot be withheld except against payees specified in the statute. If the bond contains a covenant to pay the tax but the mortgage does not, or vice versa, the tax must be withheld under this provision. Where neither bonds nor the trust deeds given by the obligor to secure them contain a tax-free covenant, supplemental agreements executed by the obligor corporation and the trustee containing a tax-free covenant and which modify the original trust deeds to that extent are of the same effect from the date of their proper execution as if they had been part of the original deeds of trust, provided proper authority exists for the modification of the trust deeds in this manner. The authority must be contained in the original trust deeds or actually secured from the bondholders.[4]

Foreign Corporations—Definition. The term "nonresident foreign corporation" is used in this chapter to include corporations not engaged in trade or business within the United States and not having any office or place of business therein. Foreign corporations which are either engaged in business within the country

[2] Revenue Act of 1921, §§ 221, 237; Revenue Act of 1918, §§ 221, 237; Reg. 45, Art. 361.

[3] Reg. 45, Art. 361; Mimeograph letter from treasury department, No. 2143, dated June 2, 1919; I. T. S. 1921, ¶ 1775. This is the ruling notwithstanding that 10% is withheld in some cases against nonresident foreign corporations for the year 1921 and 12½% for subsequent years.

[4] O. D. 414, T. B. 12-20-797.

or have an office or place of business therein are referred to as "resident foreign corporations."[5]

Rate of Tax to Be Withheld. If the covenant specifies that a tax of 1% will be paid, 2% must nevertheless be withheld; 1% being assumed by the debtor corporation and the other 1% by the bondholder. In such cases only 99% of the full amount of interest should be paid to the bondholder. If the covenant specifies that more than 2% will be paid by the debtor corporation, only 2% may be withheld, the covenant being inoperative under the law with respect to any additional amount specified therein. In the case of payments to nonresident aliens or nonresident foreign corporations, only 2% may be withheld on obligations containing tax-free covenants, notwithstanding that on other income 8%, 10% or 12½% is required to be withheld in such cases. Obligations of individuals or partnerships, whether or not containing tax-free covenants, do not require withholding at the 2% rate or at any rate against citizens, residents, domestic corporations, or resident foreign corporations. If the bond, mortgage, deed of trust, or similar obligation does not contain a contract or provision obligating the debtor (a) to pay some portion of the tax imposed by the Revenue Act of 1921 on the creditor, or (b) to reimburse the creditor for any portion of the tax, or (c) to pay the interest without deduction for any tax which the debtor may be required or permitted to pay thereon, or to retain therefrom, under the laws of the United States, the debtor corporation can not voluntarily undertake to withhold the tax under this provision and thereby assume the tax for its bondholders. Obligations of corporations other than bonds, mortgages, deeds of trust or similar obligations do not require withholding at the 2% rate or at any rate against citizens, residents, domestic corporations or resident foreign corporations.[6] A domestic corporation owning no property and doing no business in the United States issuing bonds containing a tax-free covenant, is not absolved from the withholding requirements in the case of bondholders who are citizens or residents of the United States. The situation is not analogous to that of interest from nonresident corporations paid to nonresident alien individuals. Such income is not taxable gross income and need not be reported by the nonresident alien individual. Such interest, however, paid to citizens and residents of the United States is taxable gross in-

[5] See Revenue Act of 1921, § 237 and Revenue Act of 1918, § 237; Reg. 45, Art. 1509.

[6] Telegram from treasury department dated June 2, 1919; I. T. S. 1921, ¶ 1779.

come, must be reported by the taxpayer, and a tax upon such income is due the United States. No exception as to withholding requirements may be made even though the amount of tax withheld and paid to the United States possession or foreign country is claimed by the bondholder as a credit against his income tax liability to the United States government.[7]

Object of Withholding Provision in Case of Tax-Free Covenant Bonds. Withholding the tax at the source at the rate of 2% on interest paid upon obligations containing tax-free covenants is not a measure designed or intended to insure the collection of revenue, as is withholding at the source generally. It is a measure whereby corporations may be compelled to pay a part of the tax which would otherwise be imposed upon the bondholder. The provision is inserted in the law on the theory that since corporations have issued bonds, mortgages, deeds of trust, or similar obligations, agreeing to pay interest thereon in full without deduction for any tax which might be required to be withheld at the source and that this provision has presumably influenced either the price at which the bonds or obligations were sold or their rate of interest, the law should compel the corporation to assume some part of the tax of the bondholder. Apparently the entire normal tax was deemed to be too great a burden and 2% was considered appropriate. No reason is advanced, however, for excluding domestic corporation bondholders from the benefits accruing to individual or partnership bondholders under "tax-free covenants." In the case of savings banks and insurance companies the advantage if given would inure ultimately to the benefit of depositors or policyholders.

Procedure of Corporation Issuing Tax-Free Covenant Bonds. Since there is a requirement in the law that a 2% tax be assumed by the corporation on interest paid to a large proportion of its bondholders where the bond contains a tax-free covenant, it becomes a matter of importance to officers of corporations to determine whether or not the covenants in the bonds, mortgages, deeds of trust, or similar obligations of their respective corporations are broad enough in general language, or specific enough, to require the assumption of the burden under the Revenue Acts of 1918 or 1921. Unless there is a legal obligation to pay the tax, or any part thereof, for the bondholder, the officers of the corporation may incur personal liability in making such payments, since the payment of the tax of a bondholder without legal compulsion would constitute a diversion of the funds of the

[7] O. D. 455, T. B. 15-20-852.

corporation to which stockholders and creditors may object. Furthermore, the corporation may incur liability for not withholding the proper amount of tax on payments to nonresident aliens or nonresident foreign corporations. The law requires that if the bond contains a covenant to pay the tax, only 2% shall be withheld, and that if the bond or obligation does not contain[8] such a covenant, 8% shall be withheld on payments to nonresident aliens. There is no authority in the law for withholding 8% and assuming to pay all or only 2% for the bondholder. Either the obligation is one which requires withholding at the rate of 2% and the assumption of the tax by the corporation, or it is one which requires withholding at the rate of 8% on payments of interest to nonresident aliens and the assumption of no part of the tax by the corporation. An examination of the covenant in each mortgage or issue of corporate bonds or similar obligations is therefore essential.

Examples of Covenants to Pay Taxes. A covenant reading as follows does not require or authorize the corporation to assume any part of the income tax of its bondholders: "Both principal and interest of this bond are payable without deduction for any taxes, assessments or other governmental charges which the company may be required to pay thereon or authorized to retain therefrom under any present or future law or requirement of the United States of America (except any federal income tax) or any state, county, municipality or other governmental subdivision thereof."[9] Many covenants to pay taxes were entered into prior to the enactment of the 1913 Law, and without contemplation of an income tax law requiring collection at the source. In such covenants no specific reference is made to an income tax and the force of the covenant with respect to the present income tax depends upon the general language used therein. One typical form reads as follows: "Both the principal and interest of this bond are payable without deduction for any tax or taxes, assessment or assessments, or other governmental charges, which the company may be required or permitted to pay thereon, or to retain therefrom, under any present or future law of the United States, or of any state, county, municipality or other lawful taxing authority thereof." Whether this form of covenant requires the corporation to pay the income tax of the bondholder, or only such taxes as are imposed on the bond or interest, as such, is an unsettled question. In a recent case it was held that a clause

8 Revenue Act of 1918, § 221; Revenue Act of 1921, § 221.

9 Letter from treasury department dated November 21, 1917; I. T. S. 1921, ¶ 1802.

in bonds issued by a corporation promising payment "without deduction from either such principal or interest, for any tax or taxes, which the Marion Hotel Company may be required to pay or retain therefrom, under any present or future law, the Marion Hotel Company agreeing to pay such tax or taxes," did not require the corporation to pay the federal income tax of the bondholder which it retained from the payment of interest on the bonds, since the tax is not a tax on the bond, but a personal obligation of the bondholder, arising out of the possession of an income in excess of the exemptions and deductions allowed by such law.[10] The Supreme Court of Massachusetts in deciding whether the income tax came within the terms of a covenant by a lessee to pay "all taxes and assessments * * * upon or in respect of the rent * * * howsoever and to whomsoever assessed," held that the 1913 Law imposed the tax "in respect of the rent" and held that the language quoted was effective to compel the tenant to assume the tax of the landlord to the extent that the law required the amounts thereof to be withheld at the source.[11] Other covenants provided that the debtor "will pay the principal and interest of these bonds without deduction for taxes." It is questionable whether or not covenants of this kind are broad enough to include taxes upon the bondholder as well as taxes assessed against the corporation upon the mortgage or bond or interest. Where a lease provided that the lessee should "pay all taxes and assessments—upon the yearly payments herein

[10] Urquhart v. Marion Hotel Co., 128 Ark. 283, 194 S. W. 1. The court referred to the early cases of Haight v. Railroad Co., 6 Wall. 15; Baltimore v. Baltimore R. R., 10 Wall. 543.

[11] Suter v. Jordan-Marsh Company, 225 Mass. 34, 113 N. E. 580. The court seemed to rest its decision in this case on the conclusion that the tax was levied upon the separate sources from which a part of the net income was derived. This conclusion appears to be against the weight of authority that the tax is on the person and not on his property. If such conclusion had been reached by the court the decision might have been different. See, however, Catawissa R. R. Co. v. Phila. & Reading Co., 255 Pa. 269, 99 Atl. 807, where the court held that the income tax was "imposed upon rental received by the lessor from the lessee." See Codman v. Amer. Piano Co., 229 Mass. 285, 118 N. E. 344. In this case it was held that where a lessee which covenanted to pay all taxes and assessments whatsoever which might be payable "for or in respect of" the leased premises during the term, except assessments for benefits, was not liable to its lessors for the amount of federal income tax on the amount of rent reserved in the lease, since while the taxes on real estate itself came within the terms of the covenant, taxes on the rentals as income did not. Taxes "for or in respect of" the leased premises were held to mean taxes relating directly to the premises themselves and not to the rent which, when due, was a separate and independent estate.

agreed to be made by the party of the second part to the party of the first part—for the payment or collection of which taxes or assessments the said party of the first part would otherwise be liable or accountable under any lawful authority whatever"; and that the lessee "should pay all taxes, charges, levies, claims, liens and assessments of any and every kind, which during the continuance of the term hereby demised, shall, in pursuance of any lawful authority, be assessed or imposed upon the demised premises, or any part thereof—all payments required to be made by the party of the first part during the term of this indenture—shall be assumed and discharged by the party of the second part as if the party of the second part were primarily liable for same," it was held that the lessee was liable for the income tax of the lessor on the ground that it was the apparent intention of the parties that the lessor should receive the amounts stipulated as rent without deduction by reason of any tax, charge or assessment of any kind and that the language was sufficiently broad to cover the federal income tax although not enacted at the time the lease was made.[12] In another case where a covenant provided that the specified rent should be paid "without any deduction, defalcation or abatement for any tax, charges or assessments whatsoever, * * * it being the express agreement of the said parties that the said covenantor, his heirs and assigns, shall pay all taxes whatsoever that shall hereafter be laid, levied or assessed by virtue of any law whatever, as well on the said hereby granted lot and buildings thereon erected or to be erected as on the said yearly rental now charged thereon," it was held that the covenant did impose an obligation upon the lessee to pay the federal income tax since it was manifestly the intention of the parties, by this covenant, to secure to the grantor the full payment of the yearly rent without any deduction, defalcation or abatement for any taxes, charges or assessments whatsoever.[13] Again, where a lease provided that the lessee should "pay all taxes, charges and assessments * * * imposed under any existing or future law on the demised premises, or any part thereof, or on the business there carried on, or on the gross receipts or net, derived therefrom, or upon the capital stock of 'the lessor' or the dividends thereon, or upon the franchises of the said company, for the payment or collection of any of which said taxes

[12] Northern Pennsylvania R. R. Co. v. Philadelphia & Reading Ry. Co. 43 Pa. C. C. 150; aff'd 249 Pa. 326, 94 Atl. 834. See also Philadelphia City P. Ry. Co. v. Philadelphia R. T. Co., 263 Pa. 561, 107 Atl. 329.

[13] Van Beil v. Brogan, 65 Pa. Super. 384, reversing 23 D. R. 1055 (Dauphin County Court, Pa. 1914). Ehrlich v. Brogan, 262 Pa. 362.

the 'lessor' may otherwise become liable," it was held that the lessee was not required to pay the federal income tax on the rental received by the lessor on the ground that such tax was not expressly mentioned and the covenant was not broad enough to discharge all liability for taxes of every kind for which the lessor should become primarily liable.[14] The cases referred to above are cases which have been decided under the 1913 or 1916 Laws. Other cases arising under different statutes are referred to in the foot note.[15] Where lessees covenant to pay all taxes which during the term of a lease may be lawfully levied, laid or assessed against the rent payable, whether levied or assessed on the same as rental or as income of any person entitled thereto, such lessees are liable to reimburse the lessor not only for the normal federal income tax, but also for the surtax paid by him on rentals received although such surtax did not come into existence until after the date of the lease, the surtax being a direct tax which may be assessed on rentals when received as income.[16] Under a clause which provided that the lessee should pay "one-third of all taxes or assessments, special or otherwise, and public charges of every kind or nature that shall or may be taxed or assessed against the Des Moines company or its property during the aforesaid term of years" it has been held that the lessee was under no obligation to pay federal income tax imposed pursuant to the 1913, 1916 and 1918 Laws upon sums received by the lessor. In making this decision the court treated the fact that at the time the covenant was made no such taxes were levied, or were apparently to be anticipated, as bearing on the intent of the parties, and held that an intent to include all possible

[14] Little Schuylkill, etc. Co. v. Philadelphia & Reading Ry. Co., 44 P. A. County Court, Rep. 197, aff'd 69 Pa. Super. 122. Allocatur to the Supreme Court has been denied. It seems in this case the intention of the lessor was to have the lessee pay any and all taxes so that the net amount of the rental could be distributed without diminution to the stockholders, but the court held that the language of the covenant was not broad enough to accomplish this purpose.

[15] Northern Trust Co. v. Buck, 263 Ill. 222, 104 N. E. 1114; Pettebone v. Smith, 150 Pa. 118, 24 Atl. 693; Chicago, etc., Ry. v. Kansas City N. W. R. R., 75 Kans. 167, 88 Pac. 1085; Erie, etc., R. R. v. Pennsylvania R. R., 208 Pa. 506, 57 Atl. 980; Clopton v. Phila. & Reading R. R. Co., 54 Pa. 356, Northern Central R. R. Co. v. Jackson, 7 Wall. 262; U. S. v. Baltimore & Ohio R. R. Co., 17 Wall. 322. See also article in Illinois Law Review, January, 1915. Phila., G. & N. R. Co., v. Phila. & R. Ry. Co., 265 Pa. 325, 108 Atl. 528.

[16] Kimball v. Cotting, 234 Mass. 172, 125 N. E. 551.

forms of taxation is not conclusively established by the use of sweeping general terms, if by a proper application of the rule of *ejusdem generis*, or other recognized canon, the covenant may be satisfied by a less burdensome construction.[17]

17 Des Moines Co. v. Chicago Gt. West. Ry. Co., 177 N. W. 90, 188 Iowa 1019.

CHAPTER 42

CONSTITUTIONALITY OF THE LAW

It is not the purpose of this chapter to discuss exhaustively the constitutional questions which may exist with respect to the present internal revenue laws, but to point out certain features of such laws with respect to which questions of constitutionality have been raised, and also to point out briefly a few general principles which may have a bearing upon the constitutionality of provisions of the Revenue Act of 1921 and the Revenue Act of 1918. It is a long established principle vital to our constitutional system that a court is not authorized to adjudge a statute unconstitutional where the question as to its constitutionality is at all doubtful, and that unless the statute is plainly and palpably unconstitutional, it will be upheld. Instead of seeking for excuses for holding acts of the legislative power void by reason of their conflict with the constitution the effort should be made to reconcile them, if possible, and not to hold the laws invalid unless the opposition between the constitution and the laws be such that the court feels a clear and strong conviction of their incompatibility with each other.[1] Unless it be impossible to avoid it, a general revenue statute should never be declared inoperative in all its parts because a particular part relating to a distinct subject, is invalid. It is an elementary principle that the same statute may be in part constitutional and in part unconstitutional, and that if the parts are wholly independent of each other that which is constitutional may stand when that which is unconstitutional is rejected. It is only when different clauses of an act are so dependent upon each other that it is evident the legislature would not have enacted one of them without the other—as when the two things provided are necessary parts of one system—that the whole act will fall with the invalidity of one clause. When there is no such connection and dependency, the act will stand, though different parts of it are rejected. A different rule might be disastrous to the financial operation of the government and produce the utmost confusion in the business of the entire country.[2] It

[1] Booth v. Illinois, 184 U. S. 431; Fletcher v. Peck, 6 Cranch 87; Brown v. Walker, 161 U. S. 591; U. S. v. Delaware & H. Co., 213 U. S. 366.

[2] Field v. Clark, 143 U. S. 649; Rainey v. U. S., 232 U. S. 310; Underwood Typewriter Co. v. Chamberlain, 92 Conn. 199, 102 Atl. 600, 254 U. S. 113; State ex rel. Manitowoc Gas Co. v. Wis. Tax Commission, 161 Wis. 111, 152 N. W. 848; Robertson v. Pratt, 13 Haw. 590; Alpha Portland

will be noted that the Revenue Act of 1921 provides expressly that if any provision or the application thereof to any person or circumstances is held invalid, the remainder of the act and the application of such provision to other persons or circumstances shall not be affected.[3]

Construction of Constitutional Provisions. Constitutions are designed by their framers and accepted by the people as enduring instruments so comprehensive and general in their terms that a free, intelligent and moral body of citizens may govern themselves under their beneficent provisions through radical changes in social, economic and industrial conditions. They declare only fundamental principles as to the form of government and the mode in which it shall be exercised. Certain great powers are conferred and some limitations as to their exercise are established. The amendments to a constitution together with the original constitution form one instrument which is to be interpreted in the light of the conditions under which its several parts were framed, the ends which it was designed to accomplish, the benefits which it was expected to confer, and the evils which it was hoped to remedy. It is a grant from the sovereign in the exercise of a delegated power. It is a statement of general principles and not a specification of details. Amendments to the constitution ought to be construed in the same spirit and according to the same rules as the original, and, in regard to questions of taxation, in connection with the taxing clauses of the original constitution, and the effect attributed to them before the amendment was adopted. The constitution is to be interpreted as the constitution of the sovereign state and not as a statute or an ordinary piece of legislation. Its words must be given a construction adapted to carry into effect its purposes.[4]

Power of Congress to Levy Income Taxes. The Sixteenth Amendment to the Federal Constitution authorized Congress "to lay and collect taxes on incomes from whatever source derived, without apportionment." As Chief Justice White has said,[5] this

Cement Co. v. Knapp, 230 N. Y. 48, 231 N. Y. 8. In income tax cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164, the court in pursuance of this rule discussed only the contentions in regard to the constitutionality of the Wisconsin Income Tax Law which might be considered as going to the validity of the whole act and declined to express any opinion as to the "minor provisions which are probably to be regarded as matters of detail."

3 Revenue Act of 1921, § 1403; Revenue Act of 1918, § 1402.

4 Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904; Eisner v. Macomber, 252 U. S. 189.

5 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

amendment does not confer power to levy income taxes in a generic sense or to limit and distinguish between one kind of income tax and another, but the whole purpose was to relieve all income taxes, when imposed, from apportionment; in short, the purpose was to do away with the principle upon which the case[6] holding the 1894 Law unconstitutional was decided. The amendment places no limitation as to the nature and character of the income taxes which it authorizes. Congress derives from the Constitution[7] its powers "to lay and collect taxes, duties, imposts and excises." This power is exhaustive and embraces every conceivable power of taxation, limited only by the constitutional provisions that "all duties, imposts, and excises shall be uniform throughout the United States,"[8] that "direct taxes shall be apportioned among the several states"[9] and that "no capitation or other direct tax, shall be laid, unless in proportion to the census."[10] The Sixteenth Amendment removed the limitation of apportionment, but did not enlarge the power of Congress.

Taxing Gains and Profits From Sale of Property. The question whether Congress has power to tax gains and profits arising from the sale of capital assets, viz., whether the word "income," as used in the Sixteenth Amendment, embraced such gains and profits, has now been definitely settled by the Supreme Court. In a number of cases recently decided[11] that court held such gains and profits to be taxable, and that no distinction existed between gains from capital realized by a single isolated sale of property and gains from capital realized by sales by one engaged in buy-

[6] Pollock v. Farmers Loan & Trust Co., 157 U. S. 429, 158 U. S. 601.

[7] Constitution of the United States, Art. 1, § 8.

[8] Id. Art. 1, § 8, Cl. 1.

[9] Id. Art. 1, § 2, Cl. 3.

[10] Id. Art. 1, § 9, Cl. 4.

[11] Walsh v. Brewster, 41 Sup. Ct. Rep. 392, T. B. 16-21-1573; Goodrich v. Edwards, 41 Sup. Ct. Rep. 390, T. B. 16-21-1572; Eldorado Coal Co. v. Mager, 65 L. Ed. 449, T. B. 16-21-1571; Merchants Loan & Trust Co. v. Smietanka, 41 Sup. Ct. Rep. 386, T. B. 16-21-1570. The court brushed aside the case of Lynch v. Turrish, 247 U. S. 221, on the ground that there was no increase after March 1, 1913, and the case of Gray v. Darlington, 15 Wall. 63, also much relied on, by referring to the difference in the statute under which the case was decided, the expressions relied on not being necessary to a decision. As bearing upon the taxation of capital gains, see generally: Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904; Hays v. Gauley Mountain Coal Co., 247 U. S. 189; Doyle v. Mitchell Bros., 247 U. S. 179; Eisner v. Macomber, 252 U. S. 189; U. S. v. Cleveland C. C. & St. L. Ry. Co., 247 U. S. 195; Stratton's Independence v. Howbert, 231 U. S. 399; Scott v. Schwab, 255 Fed. 57.

ing and selling as a business—a merchant, real estate agent or broker.

Requiring Disclosure of Interest on State and Municipal Obligations. Although the Revenue Act of 1918 expressly exempts from taxation interest upon the obligations of a state or any political subdivision thereof, presumably because a *tax* on such interest would be unconstitutional, it requires any person owning such obligations to submit a statement showing the number and amount thereof and the income received therefrom, in such manner and form and with such information as the commissioner shall require.[12] It has been asserted that this provision is unconstitutional in that it imposes the burden upon state and municipal obligations of compelling the owner to make a computation and disclosure of his income therefrom—a burden which if admitted in principle, could be stretched to such an extent that the owner would prefer to pay the tax in order to escape the greater burden of supplying the government with a mass of detail in regard to his ownership of such securities. Congress seems to have no general power to make inquiry into the affairs of a citizen or to investigate the affairs of citizens as a mere matter of private concern or governmental curiosity,[13] and an individual may refuse to answer an unauthorized inquiry.[14] Regarding the question from the standpoint of individual liberty and privacy or from the standpoint of authority in a particular case to make inquiry and compel answer, it is difficult to see in the above inquiry introduced by the Revenue Act of 1918 as to state and municipal obligations any legitimate purpose connected with the raising of revenue or any other function of the federal government. It does not seem that taxpayers should be obliged to speculate as to a possible undisclosed purpose on the part of Congress which might render the provision authorized and proper. The provision has been withdrawn in the Revenue Act of 1921.

Want of Due Process of Law. The due process clause of the Fifth Amendment to the Federal Constitution which provides that "nor (shall any person) be deprived of life, liberty, or property without due process of law," is not a limitation upon the taxing power conferred upon Congress by the Constitution; in

[12] Revenue Act of 1918, § 213 (a) 4.

[13] See Interstate Commerce Commission v. Brinson, 154 U .S. 447, 478; In re Chapman, 166 U. S. 661, 668; Kilbourn v. Thompson, 103 U. S. 168; Harriman v. Interstate Commerce Commission, 211 U. S. 407; In re Pacific Ry. Commission, 32 Fed. 241.

[14] Boyd v. U. S., 116 U. S. 616.

other words, the Constitution is not self-destructive and does not conflict with itself by conferring on the one hand a taxing power and taking the same away on the other by the limitations of the due process clause. To make a tax statute unconstitutional the seeming exercise of the taxing power of the act must be so arbitrary as to constrain to the conclusion that it is not the exertion of taxation, but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, that the statute is so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion. In other words, the Constitution simply requires that a statute shall operate on all alike under the same circumstances.[15] The judicial department cannot prescribe to the legislative department limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon persons; but the responsibility of the legislature is not to the courts but to the people by whom its members are elected. A tax will, therefore, not be held void because it is deemed to be too high.[16] In a case arising under the 1909 law it has been held that the provision limiting the interest deduction of a corporation to the amount of "paid-up capital stock * * outstanding at the close of the year" was not unconstitutional because it denied equal protection of the law to the corporation issuing its stock at a premium. Congress may impose different specific taxes upon different trades and professions and vary the rates of excises upon various products. It may tax real estate and personal property in a different manner. It may allow deductions for indebtedness or not allow them. Such regulations of this character, so long as they proceed within reasonable limits and general usage, are within the discretion of Congress. There is no precise application of the rule of reasonableness of classification and the rule of equality permits of many practical inequalities. The rule of equality under the Constitution only requires that the law imposing it shall operate on all alike under the same circumstances.[17] In a case arising under the 1913 Law[18] the Supreme Court enumerated a number of features of the 1913 Law which, it had been alleged, constituted a violation of the due process clause, and dismissed them with the statement that

[15] Brushaber v. Union Pacific R. R. Co., 240 U. S. 1, see next paragraph on Uniformity.

[16] McCray v. U. S., 195 U. S. 27; Spencer v. Merchant, 125 U. S. 345.

[17] N. Y., N. H. & H. R. R. Co. v. U. S., Ct. D. 3, T. B. 3-21-1400.

[18] Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

none in the remotest degree presented such questions. Among such objections were the following: (1) that the progressive rate and exemption features of the law were based on wealth alone and were wanting in due process of law,[19] (2) that the duty cast upon corporations of collecting the tax at the source was wanting in due process of law, (a) because of the cost to which they were subjected, (b) because of the resulting discrimination between corporations indebted upon coupon and registered bonds and corporations not so indebted, (c) because of the further discrimination in the case of corporations so indebted which had assumed the payment of taxes on their bonds, (d) because of the further discrimination against corporate bondholders in the deprivation of the use of their money between the deduction and payment of the tax withheld, (e) because of the further discrimination against corporate bondholders in the fact that they might be obliged to pay the tax a second time if the corporation should fail after deduction, and (f) because of a further discrimination against bondholders in that they were not relieved of the duty of reporting bond income by payment at the source, the result being a double payment of the tax, labor and expense in obtaining a refund and deprivation of the use of their money in the meantime; (3) that the limitation on the amount of interest deductible by corporations was wanting in due process; (4) that the privilege granted to individuals of deducting dividends for purposes of normal tax was a discrimination against corporations;[20] (5) that the deduction of $3,000

[19] Speaking of the progressive feature of the Wisconsin Income Tax Law, the Wisconsin Court said in the Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164: "With regard to the progressive feature, it is aptly said in Knowlton v. Moore, 178 U. S. 41, at p. 109, 20 Sup. Ct. 747, by the present chief justice, that 'taxes imposed with reference to ability of the person upon whom the burden is placed to bear the same have been levied from the foundation of the government. So, also, some authoritative thinkers, and a number of economic writers, contend that a progressive tax is more just and equal than a proportional one. In the absence of constitutional limitation, the question whether it is or is not is legislative and not judicial.'"

[20] In holding that the application of a different rate in the case of corporations and individuals was permissible, the Wisconsin Court said in the Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164: "The corporate privileges, which are exclusively held by corporations, and the real differences between the situation of a corporation and an individual, among which may be mentioned the fact that the corporation never is obliged to pay an inheritance tax, plainly justify a difference of treatment in the levying of the income tax. Were the income tax a tax upon property, there could be no difference in rate, for taxation of property must still be on a

or $4,000 to those who pay the normal tax and not to those with incomes over $20,000 was wanting in due process;[21] (6) that the discrimination between married and single people and between husbands and wives living together and husbands and wives not living together was wanting in due process;[22] (7) that the law involved a discrimination and want of due process in favor of house owners living in their own houses who were not compelled to estimate the rental value against those who paid rent and were not allowed to deduct it and in favor of farmers who might deduct products of the farm used by them in sustaining their families whereas family expenses might not, as a rule, be deducted. In another case[23] it was held there exists a substantial difference between the carrying on of business by corporations and the same business by a private firm or individual, and the 1909 Law was, therefore, not unconstitutional on the ground of arbitrary discrimination. In another case the court held that the fact that the tax was levied on the income of mining companies without making adequate allowance for depletion did not amount to the taking of property without due process of law.[24] In a case[25] arising under the law taxing foreign-built yachts it was stated by the court that the distinction between

uniform rule, but, as has been heretofore noted, it is not a tax upon property within the meaning of our Constitution."

[21] In Campbell v. Shaw, 11 Haw. 112, it was held that the Hawaiian Income Tax Act of 1896 was unconstitutional by reason of the fact that it allowed an exemption of $2,000 on incomes under $4,000, whereas no such exemption was allowed on incomes over $4,000. In Robertson v. Pratt, 13 Haw. 590, it was decided that an exemption of incomes to the amount of $1,000 was not invalid on the ground that it was excessive. See also Peacock v. Pratt, 121 Fed. 772; In re Income Tax Act, 10 Haw. 317.

[22] With regard to the provision of the Wisconsin Income Tax Law that the income of a wife living with her husband shall be added to the income of the husband, the Wisconsin court said in the Income Tax Cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164: "This is another case of classification, and it is only justifiable in case there is some substantial difference of situation which suggests the advisability of difference of treatment. We think there clearly is such a difference, in this, that experience has demonstrated that otherwise there will be many opportunities for fraud and evasion of the law, which the close relationship of husband and wife or parent and child makes possible, if not easy. The temptation to make colorable shifts and transfers of property in order to secure double or even triple exemptions, if there were not some provision of this kind in the law, would unquestionably be very great. There is no such temptation or opportunity in the case of the single man, or the man and wife who are living separately."

[23] Flint v. Stone-Tracy Co., 220 U. S. 107.

[24] Stanton v. Baltic Mining Co., 240 U. S. 103.

[25] Billings v. U. S., 232 U. S. 261.

things foreign and things domestic, and their use, was apparent on the face of things and to tax them separately was not an arbitrary discrimination.

Uniformity. The provision of the Fifth Amendment to the Constitution of the United States which prescribes that "nor (shall any person) be deprived of life, liberty, or property without due process of law" is not an equal protection clause and should not be confused with the Fourteenth Amendment which prescribes that "nor (shall any state) deny to any person within its jurisdiction the equal protection of its laws."[26] The only uniformity prescribed with reference to duties, imposts and excises is a geographical or territorial uniformity.[27] In a recent case the Supreme Court has held that the provisions of the 1917 Excess-Profits Tax Law defining invested capital according to original cost of property instead of present value, does not render the act "glaringly unequal" and of "doubtful constitutionality."[28] In this case the Supreme Court said: "The difficulty of adjusting any system of taxation so as to render it precisely equal in its bearing is proverbial, and such nicety is not even required of the states under the equal protection clause, much less of Congress under the more general requirement of due process of law in taxation. Of course, it will be understood that Congress has very ample authority to adjust its income taxes according to its discretion within the bonds of geographical uniformity."

Exempting Certain Corporations from Tax. The provision of the Sixteenth Amendment authorizing a tax on incomes "from whatever source derived" does not require that the tax must be imposed upon all sources of income nor does it exclude the power to exempt certain classes of corporations.[29]

Retroactive Features. The right of Congress to impose a tax by a new statute, although the measure of the tax is governed by

26 See Constitution of the United States, Art. 14, § 1.

27 See Constitution of the United States, Art. 1, § 8. See also La Belle Iron Works v. United States, 41 Sup. Ct. Rep. 528, T. B. 23-21-1680; Knowlton v. Moore, 178 U. S. 41; Patton v. Brady, 184 U. S. 608; Flint v. Stone-Tracy Co., 220 U. S. 107; Billings v. U. S., 232 U. S. 261; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

28 LaBelle Iron Works v. U. S., 41 Sup. Ct. Rep. 528. In Ehret Co. v. Lederer, 273 Fed. 689, it was held that the Commissioner's construction of § 201 of the 1917 Law, particularly the phrase "the amount of the net income in excess of the deduction," was not unconstitutional. (See Chapter 43.)

29 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

the income of the past year cannot be doubted; much less can it be doubted that Congress may impose a tax on income of the current year, though part of that year has elapsed when the statute is passed.[30] A statute imposing a tax upon all income of a previous year, although one tax on that income has already been paid, is valid.[31]

[30] Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Billings v. U. S., 232 U. S. 261; Stockdale v. Insurance Companies, 20 Wall. 323; Schuylkill Nav. Co. v. Elliott, 21 Fed. Case. No. 12, 497; Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654, T. B. 2494; U. S. v. McHatton, 266 Fed. 602; A. R. R. 565, T. B. 29-21-1737. With regard to the retroactive feature of the Wisconsin Income Tax Law the Wisconsin court in the income tax cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164, overruled objection "without comment, for the reason that it seems very unsubstantial."

[31] Stockdale v. Insurance Companies, 20 Wall. 323.

CHAPTER 43

WAR-PROFITS AND EXCESS-PROFITS TAX

The Revenue Act of 1921 re-enacts without change, the excess-profits tax imposed by the 1918 Law, but provides for its repeal as of December 31, 1921.[1] Certain provisions of the 1918 Law referring only to the war-profits tax for the year 1918 are omitted from the Revenue Act of 1921, and the 1921 Law contains provisions made necessary by the limitation of the tax to the calendar year 1921. These provisions are set forth in the appropriate paragraphs of this chapter. It is to be noted that the excess-profits tax is upon net income as computed under the 1921 Law, which because of changes made in the income tax may be different from net income as computed under the 1918 Law. This will, of course, make a difference between the excess-profits tax imposed by the 1918 Law and that imposed by the 1921 Law. Other changes made by the 1921 Law occur by reason of changes made in respect to the income tax. Among such changes are the classification of certain domestic corporations as foreign corporations and a modification of the definition of inadmissible assets.

The repeal of the excess-profits tax was stated by the senate finance committee to be "because of its inequalities and difficulty of administration and because of the manner in which it discriminates against corporations with small invested capital."[2] Many other criticisms have been leveled at this tax and it was also found that it was rapidly losing its productivity.

The Act of March 3, 1917, was the first excess-profits tax law enacted in this country.[3] It was applied only to corporations and partnerships and imposed a tax of 8% on all net income in excess of the sum of $5,000 plus 8% of the actual capital invested.[4] A small amount of tax was collected under this statute for cor-

1 This repeal is accomplished by limiting the tax to the calendar year 1921. Title III of the Revenue Act of 1921 takes effect as of January 1, 1921 (§ 338).

2 Report of senate finance committee on the revenue bill of 1921, p. 23.

3 39 Stats. at Large 1000.

4 The statute defined the term "actual capital invested" to mean (1) actual cash paid in; (2) the actual cash value at the time of payment of assets other than cash paid in, and (3) paid in or earned surplus and undivided profits used or employed in the business; but to exclude money or other property borrowed.

porations whose fiscal years ended in the succeeding months but any amounts so collected were credited or refunded to the taxpayers. The next law, enacted October 3, 1917, imposed a tax on the net income of individuals, partnerships and corporations, derived from any business or trade. This latter statute (referred to in this Chapter as the 1917 Law) was retroactive to January 1, 1917, and covered the period during which the Act of March 3, 1917, had been in effect. The rates of the 1917 Law as applied to corporations having invested capital were 20% of that part of the net income which exceeded the excess-profits deduction and did not exceed 15% of the invested capital; 25% of that part of the net income which exceeded 15% of the invested capital and did not exceed 20% of the invested capital; 35% of the net income which exceeded 20% of the invested capital and did not exceed 25% of the invested capital; 45% of that part of the net income which exceeded 25% of the invested capital and did not exceed 33% of the invested capital; and 60% of that part of the net income which exceeded 33% of the invested capital.[5] In the case of a trade or business which had no invested capital or not more than a nominal capital, the excess-profits tax was 8% of the entire net income in excess of $3,000 in the case of a domestic corporation, and $6,000 in the case of a domestic partnership, or a citizen or resident of the United States. In the case of a foreign corporation or partnership or a nonresident alien this rate was imposed upon the entire net income without deduction.[6] The Act of February 24, 1919, (referred to in this chapter as the Revenue Act of 1918 or the 1918 Law) imposed a tax on income received during the year 1918 in lieu of the tax imposed by the 1917 Law. In view of the increased individual normal and surtax rates upon the income of individuals and partnerships, which in most cases made the income taxes paid by such individuals as high as the income and excess-profits or war-profits taxes paid by corporations engaged in similar business, and in view of the difficulty in administering an excess-profits tax applicable to individuals, it was decided by Congress that the war and excess-profits taxes should apply to corporations only.[7] It was also recognized that there exists a class of corporations which require very little or no invested capital and whose income is derived mainly from the personal services of the

[5] Revenue Act of 1917, § 201.
[6] Revenue Act of 1917, § 209.
[7] Report of the committee on ways and means on the Revenue Bill of 1918, September 3, 1918.

stockholders. Examples of such corporations are corporations composed of engineers or accountants, who might as readily have formed partnerships to carry on their business. Such corporations are called "personal service corporations" and were treated as though they were partnerships. No excess-profits tax was imposed upon their net income but the stockholders of the personal service corporation were taxable upon the entire net income of the year, whether or not such income is distributed in the form of dividends. The tax imposed by the 1918 Law combined two general principles of taxation: (a) that of a war-profits tax, which is usually considered to be a tax on the excess of profits made during the years of the war period over the normal profits of the years prior to the war and (b) an excess-profits tax, which is considered as a tax upon the profits in excess of a specified percentage representing an approximate normal return on the invested capital. The law, however, did not adhere to a clear distinction between war-profits and excess-profits since the war-profits tax combined a feature of the excess-profits tax in that a minimum deduction of 10% of the invested capital was allowed regardless of the earnings of the corporation during the pre-war period. Under the excess-profits method of computing the tax the rate of 1918 was 30% of that part of the net income which exceeded the excess-profits deduction and did not exceed 20% of the invested capital and 65% of that part of the income which exceeded 20% of the invested capital. The war-profits tax rate was a single rate of 80% in excess of the war-profits credit.[8] This combination of principles applied generally, however, only to income of the year 1918. For subsequent years the war-profits tax is discarded and the excess-profits tax alone imposed, except as to income received from government contracts, as more fully stated in a following paragraph. The rate of the excess-profits tax for the taxable years 1919, 1920 and 1921 is 20% on that part of the net income which exceeds the excess-profits credit and does not exceed 20% of the invested capital, and 40% on the remaining net income.[9]

[8] Revenue Act of 1918, § 301 (a). It has been estimated that under the 1917 Law, the average amount of excess-profits tax was about 30% of the net income of taxable corporations for the year 1917. It has been conjectured that the war-profits and excess-profits taxes absorbed on an average about 45% of the 1918 income. In addition the income tax absorbed 12% of the remainder so that probably about one-half of the net income of corporations for the year 1918 was paid to the federal government by way of war-profits, excess-profits and income taxes.

[9] Revenue Act of 1921, § 301 (a); Revenue Act of 1918, § 301 (b).

Individuals. Individuals are not subject to the excess-profits tax. Since individuals were not allowed to file returns on the basis of their fiscal years under the 1917 Law, no individual paid a tax on 1918 income under the 1917 Law, and, therefore, the 1918 Law contains no provision with respect to individuals such as the provision [10] with respect to partnerships for redetermining the tax due on 1917 income.

INDIVIDUALS UNDER 1917 LAW. Under the Revenue Act of 1917, individuals were subject to excess-profits tax if they had an aggregate net income in excess of $6,000 ($3,000 in the case of nonresident aliens) from trades, businesses, occupations or professions.[11]

In the case of an individual, the terms "trade," "business," and "trade or business" were held to comprehend all his activities for gain, profit, or livelihood, entered into with sufficient frequency or occupying such portion of his time or attention as to constitute a vocation, including occupations and professions. When such activities constituted a vocation they were construed to be a trade or business whether continuously carried on during the taxable year or not, and all the income arising therefrom was subject to excess-profits tax.

In the following cases the gain or income was not subject to excess-profits tax, and the capital from which such gain or income is derived could not be included in "invested capital": (a) Gains or profits from transactions entered into for profit, but which are isolated, incidental, or so infrequent as not to constitute an occupation, and (b) the income from property arising merely from its ownership, including interest, rent, and similar income from investments except in those cases in which the management of such investments really constitutes a trade or business.[12]

[10] Revenue Act of 1918, § 335 (c).

[11] Revenue Act of 1917, §§ 201, 202 and 203; Reg. 41, Art. 12-13. The term "trade or business" is also defined in Chapters 25 and 44.

[12] Reg. 41, Art. 8. This ruling has received the attention of the court in Cadwalader v. Lederer, 273 Fed. 879, in a decision in which it was held that commissions received by a lawyer as executor and trustee of the estate of a friend were not subject to the 1917 excess-profits tax, where it appeared that the lawyer did not make a general practice of so acting, the court says in this case that it cannot "grasp the thought of a distinction between such isolated things, growing out of the importance of the thing done or the demands which it makes upon the time of the person doing it". It then explains article 8 of regulations 41, as follows: "The whole thought is conveyed in an expression which is not uncommon when a person is asked to do something which, as another expression goes, is 'out of line'.

Several cases arose under the Revenue Act of 1917 in definition of the terms "trade" and "business" a few of which are given below:

(1) An expert oil man who devoted his time and money to the purchase and sale of oil and gas leases and to the promotion of corporations developing such leases, and who in 1917 disposed of his entire holdings of the capital stock of certain corporations in which he owned all but the qualifying shares and of which he was an active officer, was held subject to the 1917 excess-profits tax on the profits realized in 1917 from the sale of his interests in such companies.[13]

(2) The sale of rights acquired through the ownership of stock in any corporation in which an individual was not a managing officer or agent was considered an isolated transaction and any profit derived therefrom was not subject to the 1917 excess-profits tax.[14]

(3) Likewise profits realized from the sale of fractional interests in various vessels by an individual having no control of the management of such vessels were not subject to the 1917 excess-profits tax unless such individual gave enough time and attention to the buying and selling thereof as to constitute a trade or business.[15]

(4) A physician who owned a farm and a part interest in certain oil interests, but who spent practically his entire time in 1917 in the practice of his profession, the farm being rented out on a cash rental basis and the management of the interest in the oil leases being in the hands of another individual was held not engaged in the business of farming or the purchase, promotion or sale of oil properties in 1917, and consequently not subject to the

The expression first referred to is, 'I don't make a business of doing this, but I will do it for you'. The doing of it may result in such person devoting practically his whole time to it, without involving the thought of making it his business. There is much the same distinction made between amateurs and professionals in athletics, although the test usually applied there is the commercial test. Nevertheless the distinction referred to exists. The amateur does not make, as the professional *ex vi termini* does, the sport his trade, occupation, business, or profession, even although he, as he not infrequently does, devotes more time in developing and perfecting skill in it than the avowed professional does. The difference is suggestive of a difference in motive, but there is the other thought also."

13 A. R. M. 41, T. B. 16-20-871. The decisive point in this decision seems to have been the fact that the taxpayer was the managing officer of the corporations.

14 A. R. M. 41, T. B. 16-20-871.

15 A. R. R. 65, T. B. 16-20-870.

1917 excess-profits tax with respect to a profit derived from the sale of the farm and the interest in the oil leases.[16]

(5) Amounts received for professional and literary work have been held to be income arising from a vocation.[17]

(6) Profits realized by an individual also engaged in farming derived from trading in grain futures have been held to constitute income from a trade or business.[18]

(7) Royalties received under a license contract by a taxpayer engaged in the automobile business who had patented certain automobile improvements have been held to be derived from a trade or business and not the mere ownership of property, where the taxpayer devoted a considerable part of his time and attention to the invention.[19]

(8) Profits derived from a cattle feeding venture have been held subject to the excess-profits tax imposed by the 1917 Law.[20]

Partnerships Under 1918 and Present Laws. Partnerships are not subject to the excess-profit tax under the 1918 or the present law.

PARTNERSHIPS UNDER 1917 LAW. Partnerships were subject to the 1917 excess-profits tax, if they had a net income of $6,000 or more ($3,000 or more in the case of a foreign partnership).[21] A partnership which was dissolved in July, 1917, was held not to be relieved from such tax on the ground that its dissolution antedated the passage of the act.[22]

The definition of partnerships has been covered in full in an earlier chapter.[23] It has been held in connection with the 1917 Law that several persons who contributed severally to a fund used to develop and operate an oil field with an agreement that they were to share *pro rata* in the profits did not constitute a

[16] A. R. M. 40, T. B. 17-20-879.

[17] A. R. R. 247, T. B. 34-20-1155. But the estate of a deceased literary man would not be liable for excess-profits tax on royalties received (O. D. 760, T. B. 52-20-1365).

[18] A. R. R. 636, T. B. 41-21-1865.

[19] A. R. R. 425, T. B. 42-21-1874. See also Delaski & Thropp Co. v. Iredell, 268 Fed. 377.

[20] A. R. R. 629, T. B. 40-21-1850. See Chapter 8.

[21] Revenue Act of 1917, §§ 201, 202 and 203; Reg. 41, Art. 11. Partnerships doing the same kind of business as exempt corporations were exempt (Reg. 41, Art. 13). See Chapter 13.

[22] A. R. R. 43, T. B. 12-20-794; Reg. 41, Art. 5. The act was passed on October 3, 1917, and made retroactive as of January 1, 1917.

[23] This chapter does not attempt to cover this subject in full and Chapter 8 should be consulted.

partnership.[24] A taxpayer and his wife who both contributed equally to a fund placed in the hands of a brokerage firm for dealing in grain futures have been held to be a partnership, where it was understood by the brokerage firm that there was to be an equal sharing of profits and losses between the taxpayer and his wife on the transaction.[25] A partnership which dissolved about 1902 and whose quick assets, good will and firm title were sold to an individual who carried on business thereafter for its individual account under the old firm name, was held subject to the 1917 excess-profits tax with respect to the profits derived from certain transactions in 1917 involving the purchase and sale of sugar.[26]

PARTNERSHIPS WHICH PAID A TAX ON 1918 INCOME. If a partnership made a return under the 1917 Law for a fiscal year beginning in 1917 and ending in 1918, and paid the tax, a certain proportion thereof was subject to refund. This amount to be refunded was to be determined by taking the same proportion of the tax so paid which the proportion of the fiscal year falling in 1918 was to the entire fiscal year. Thus, if one-fourth of the fiscal year fell in 1917 and three-fourths in 1918, three-fourths of the tax which had been paid was subject to refund.[27]

Personal Service Corporations. Personal service corporations are not subject to the excess-profits tax, but are taxed as partnerships.[28] Such corporations are described in a preceding chapter.[29]

PERSONAL SERVICE CORPORATIONS UNDER 1917 LAW. The 1917 Law imposed a tax of 8% upon a trade or business having no invested capital or not more than a nominal capital, and upon the salaries, wages and fees of individuals.[30] This pro-

[24] Sol. Op. 117, T. B. 33-21-1772.

[25] A. R. R. 636, T. B. 41-21-1865. Checks for profits were made to the husband in this case as agent for the wife, but were invested in liberty bonds which were equally divided and registered in their separate names.

[26] A. R. R. 211, T. B. 31-20-1108.

[27] Revenue Act of 1918, § 335 (c). See Chapter 37. Excess-profits tax paid by partnership with respect to income received during 1918 can not be applied as credit to tax due from individual members for taxable year 1918. In such cases claim for refund should be filed by the partnership. (O. D. 180, T. B. 7-19-310.)

[28] Revenue Act of 1921, §§ 300 and 200; Revenue Act of 1918, §§ 300 and 200.

[29] See Chapter 11. Personal service corporations are abolished as of December 31, 1921, but the excess-profits tax is repealed as of the same date.

[30] Revenue Act of 1917, § 209; Reg. 41, Arts. 14, 15.

vision was omitted from the 1918 Law, but in its place were the provisions respecting personal service corporations. Under the 1917 Law it was held that business concerns which rendered professional or personal services would not be taxed on the basis of invested capital merely because of the capital, if the employment of such capital was necessitated by delay and irregularity in the receipt of fees, etc., or if such capital was wholly or mainly used as a fund from which to advance salaries, wages, etc., or provide office furniture, accommodations and equipment, nor because of the form of organization, whether corporation or partnership, nor in the case of a partnership because of the number of partners. Agents and brokers were held to be taxable at the graduated rates with reference to invested capital if they employed a substantial amount of capital whether to lend to principals or to carry goods on their own account, but otherwise were taxable only at the flat rate of 8%.[31] In determining whether a concern was taxable at the 8% rate no weight was given to the fact that it was carried on by means of personal service, unless the principal owners were regularly engaged in the active conduct of the trade or business.[32] It was held that the term nominal capital meant, in general, a small or negligible capital the use of which was incidental. The following trades or businesses were held to employ more than a nominal capital:

(a) A business which, because of conditions arising from the war or exceptional opportunities for profits, earned a disproportionately high rate of profit during the taxable year, if it belonged to a class necessarily and customarily requiring capital for its operation, stress to be laid in doubtful cases upon the nominal relation of net income to capital during pre-war years.

(b) Corporations which, although their capitalization was nominal, in fact employed a substantial capital in their business.

(c) A business having a substantial capital, which by the ordinary rules and restrictions governing the computation of invested capital was reduced to a nominal amount; e. g., where capital consisting originally of a small amount of cash paid in had since appreciated in value, or where capital was largely covered by indebtedness or consisted principally of tax-free securities or intangible assets built up or developed by expenditures regularly deducted as business expense.[33]

31 Reg. 41, Arts. 72, 73.
32 Reg. 41, Art. 71.
33 Reg. 41, Art. 74.

The following concerns and businesses have been held taxable under the 1917 Law in the ordinary way, because they employed more than a nominal capital:[34]

(1) A company which had never owned any lands, timber, plant, mill or yard, and which had never done any manufacturing or carried any stock of manufactured lumber, but whose principal business consisted of buying lumber from manufacturers and reselling the same to its own customers, such business being conducted by the partners personally with the assistance of a small clerical office force of one bookkeeper and two stenographers.[35]

(2) A company organized with a small amount of capital stock, none of which was paid up, and which later secured a lease to wharf property, no bonus being paid for the lease, the business of the company being subletting this leased property, its income being held derived chiefly from the possession of a capital asset which was not capital in name only, but a real tangible asset.[36]

(3) A retailing corporation, the stock of which was owned by two stockholders who were actively engaged in the business and were the principal salesmen, and which employed no capital except in paying for merchandise consigned to it by the factory and for the payment of the freight charges thereon, even though the capital used was small in amount and even though the direct use of capital by the corporation could have been avoided by having the purchasers make the customary deposits when placing their orders, no stock being carried by the corporation other than that passing through the shop for test before delivery.[37]

(4) A corporation which had spent its earnings in improving a secret chemical process (admitted to be an intangible asset) the increased value of which process was due to the improvement being in effect "earned surplus used in the business," where the improvement was originally paid for with borrowed money and

[34] This chapter does not attempt to cover this subject in full and Chapter 8 should be consulted.

[35] Cartier-Holland Lumber Co. v. Doyle, U. S. Dist. Ct., W. Dist. Mich. So. Div.; T. D. 3080. In making this decision, the court said: "They buy and sell lumber and undertake and assume all the risks and enjoy all the benefits of a merchandising business. They employ a large amount of capital; their income is dependent upon their personal services and efforts only in the same way that the farmer, who works his own farm, or the merchant who conducts his own store derives his income from his individual endeavors".

[36] A. R. R. 315, T. B. 46-20-1307.

[37] T. B. R. 58, T. B. 19-19-492.

subsequent earnings were sufficient to repay the borrowed money and to create an "earned surplus" before the beginning of the year.[38]

A corporation engaged in the business of negotiating sales of real estate for clients and the collection of rents of properties listed with it for renting, its total income being derived from commissions on such business, the corporation not owning any real estate and all its stockholders devoting their entire time and attention to the business with the exception of one stockholder owning 10 shares out of 500 (who devoted part of his time in the business) and employing two salesmen on the basis of commissions on the sales made by them, but only a small proportion of the net income being due to the activities of these salesmen, has been held taxable at the 8% rate.[39]

PERSONAL SERVICE CORPORATIONS WHICH PAID A TAX ON 1918 INCOME. If any corporation which under the 1918 Law was held to be a personal service corporation filed a return and paid a tax under the 1917 Law for a fiscal year beginning in 1917 and ending in 1918, a portion of the tax so paid was subject to refund. The amount to be refunded was determined by taking the same proportion of the tax so paid which the proportion of the fiscal year falling in 1918 was to the entire fiscal year. Thus, if five months of the fiscal year fell in the calendar year 1918, five-twelfths of the tax paid on the income of the full fiscal year was subject to refund.[40]

Corporations Engaged Partly in Personal Service Business. Where a part of the net income of a corporation is derived (1) from a trade or business (or a branch thereof) in which the employment of capital is necessary and (2) a part (constituting not less than 30% of its total net income) is derived from a separate trade or business which, if it constituted the sole trade or business, would bring the corporation within the class of personal service corporations, the tax upon that part of the

[38] Lincoln Chemical Co. v. Edwards, 272 Fed. 142; T. D. 3183, T. B. 29-21-1740. In this case Judge Hand assumed, without deciding, that "nominal capital" meant "nominal invested capital". The term "nominal capital" is a relative term. In this case the value of the process in 1917 was shown to be only over $10,000, but this was, to use the language of the court in regard to an earned surplus of $2,000, "in view of the size of the business" more than nominal.

[39] A. R. R. 210, T. B. 31-20-1097. No attempt is made in this chapter to cover all the rulings in this connection. Chapter 11 should be consulted.

[40] Revenue Act of 1918, § 335 (c). See Chapter 37.

net income which is derived from the use of capital is separately computed (allowing in such computation only the same proportionate part of the war-profits and excess-profits credits) and the tax upon the second part of the net income is the same percentage thereof as the tax computed upon the first part of the net income is of such first part.[41] This provision will apply in the case of partial personal service corporations until the point is reached where the nonpersonal-service element becomes negligible, under which conditions such corporations would make returns as personal service corporations.[42] Where a corporation doing a commission and brokerage business satisfies the requirements of a personal service corporation, except that it in part employs capital, surplus, and borrowed funds to make large advances to customers and receives more interest than it pays as a result of such transactions, it should be assessed under this provision. The income from commissions and brokerage should be considered as arising from personal service, and the remainder of the income as derived from the use of capital.[43]

Apportionment of Invested Capital and Net Income. For the purpose of determining whether or not a corporation partly partaking of the nature of a personal service corporation is within the scope of the statute and also for the purpose of establishing the basis for the computation of the tax, the corporation is required to apportion or allocate its invested capital between each trade or business or branch thereof as nearly as may be in accordance with the actual facts, and to submit with its return an explanatory statement setting forth the manner in which the apportionment of the invested capital employed in the production of each part of its net income has been determined. There must be assigned to any personal service trade or business or branch thereof an amount of invested capital at least as great as that which would ordinarily be employed by a personal service corporation of similar size and standing for the payment of salaries and office expenses, maintenance of library and equipment, credit advances to clients, etc.[44]

Computation of Tax Upon Net Income. (1) The tax upon the nonpersonal service part of the net income is computed

41 Revenue Act of 1921, § 303; Revenue Act of 1918, § 303.

42 O. D. 79, T. B. 1-19-114.

43 T. B. M. 50, T. B. 12-19-410.

44 Reg. 45, Art. 741. For the method of determining the portion of the net income from each trade or business or branch thereof see p. 1030.

upon the basis of (a) such part of the entire average net income for the prewar period as was derived from the same trade or business or branch thereof; (b) such part of the entire average invested capital for the prewar period as was employed in the production of the part of the net income for that period determined under (a) ; (c) such part of the entire invested capital for the taxable year as has been employed in the production of the net income upon which the tax is being computed; and (d) the same proportion of the specific exemption and credits as the proportion which the part of the net income upon which the tax is being computed is of the entire net income. If the corporation was in existence during the prewar period, but did not conduct this trade or business or branch thereof during that period, the war-profits credit is 10% of the invested capital for the taxable year. (2) The tax upon the personal service part of the net income is the same percentage thereof as the tax computed under (1) is of the nonpersonal service part of the net income. The tax under this paragraph may in no case be less than 20% of the personal service part of the entire net income, unless the tax upon the entire net income if computed in the ordinary way would be less than 20% of such entire net income. In that event, and in any case in which the amount of the total tax as computed above is the same as or greater than the tax as computed in the ordinary way, the tax must be computed as if all the income was derived from the use of capital.[45]

Corporations. All corporations except those expressly exempt by the statute are subject to the excess-profits tax. The term "corporations" includes associations, joint-stock companies and insurance companies.[46] A corporation dissolved prior to February 25, 1919, when the 1918 Law went into effect, but which was in receipt of income after January 1, 1918, was subject to the tax imposed by the 1918 Law for the reason that the law was retroactive to the first day of January, 1918.[47]

EXEMPT CORPORATIONS. Corporations exempt from the income tax are also exempt for the purpose of excess-profits tax.[48]

45 Reg. 45, Art. 742. See illustration No. 5, appendix to the 1920 edition.

46 See letter from treasury department dated November 17, 1917; W. T. S. 1919, ¶ 757.

47 See Chapter 10. Every corporation was taxable under the 1917 Law if it had a net income of more than $3,000, or in the case of a foreign corporation of $3,000 or more from sources within the United States (Revenue Act of 1917, §§ 201, 202 and 203; Reg. 41, Art 10).

48 Revenue Act of 1921, § 304; Revenue Act of 1918, § 304 (a). See Chapter 13 for a list of exempt corporations under the income tax law.

In addition, any corporation whose net income for the full taxable year of twelve months is less than $3,000 is exempt from this tax. If the taxable period is less than twelve months the corporation is exempt from the tax, if its net income for the period is less than the same proportion of $3,000 as the number of months in the period is of twelve months, any fractional part of a month being counted as the number of days in such part of a month divided by 30.[49]

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. Special provisions apply to corporations deriving income from government contracts as defined in the following paragraph. For the taxable year 1919 and thereafter every corporation which derives in such year a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will be required to pay the tax at the 1918 rates on the net income attributable to such government contracts, such tax to be computed according to the rule stated in a subsequent paragraph.[50] Corporations which have no prewar period and which were in receipt of 50% or more of gross income during the taxable year from gains, profits, commissions of other income derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will be limited to a war-profits credit of 10% of the invested capital of the taxable year,[51] although other corporations (other than corporations a majority of whose stock at any time during the taxable year is owned or controlled, directly or indirectly, by a corporation which was in existence during the whole of at least one calendar year during the prewar period) which had no prewar period may claim a higher deduction if the earnings of similar corporations during the prewar period were more than 10%. Corporations 50% or more of whose gross income for the taxable year consists of gains, profits, commissions or other income derived on a cost-plus basis from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will not be allowed to avail themselves of the remedial provision which will permit other corporations to be assessed on the basis of the tax paid by

[49] Revenue Act of 1921, § 304 (b); Revenue Act of 1918, § 304 (b); Reg. 45, Art. 751.

[50] Revenue Act of 1921, § 301 (b); Revenue Act of 1918, § 301 (c). See p. 1036 and illustration No. 4, appendix of 1920 edition.

[51] Revenue Act of 1918, § 311 (d).

representative corporations.[52] It is to be noted that the first two provisions refer to government contracts generally while the third provision is limited to cost-plus contracts. A corporation organized after August 1, 1914, and not a successor to a then existing business, 50% or more of whose gross income consists of gains, profits, commissions or other income derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, can not be considered as affiliated with any other corporation for the purpose of making consolidated returns.[53]

If in 1919 a corporation derives a profit in excess of $10,000 from government contracts, but sustains a net loss on other operations, it may deduct the amount of such loss in ascertaining its net income subject to tax. If the amount of the excess-profits credits exceeds the company's total net income from all sources for 1919 no tax will be imposed upon the portion of its net income for that year which was derived from government contracts.[54]

GOVERNMENT CONTRACTS. A government contract is defined in the law to be (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive," when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.[55] The same applies to procurement orders issued after November 11, 1918, in confirmation of informal orders entered into prior to November 12, 1918.[56] The term "contract" has a definite com-

[52] Revenue Act of 1918, § 327 (d). See p. 1116.

[53] Revenue Act of 1918, § 240 (a). See p. 1132.

[54] O. D. 532, T. B. 22-20-979. Since the company's net income included an item of net profit from government contracts in excess of $10,000, it will be required to supply fully all of the data called for by the supporting schedules of form 1120-S.

[55] Revenue Act of 1918, § 1; Revenue Act of 1921, § 200.

[56] O. D. 394, T. B. 5-20-721.

mercial meaning and is broad enough to include any reciprocal promise or engagement whether or not evidenced by a formally executed document. It may be either oral or written, and a contract entered into with an agent is binding upon the principal. The fact that a formal contract was executed after November 11, 1918, would not affect the status of the original contract unless such contract was thereby revoked or supplanted, but would be further evidence of the contract and in confirmation of it. The fact that a formally executed contract bears a date subsequent to the date of offer and acceptance, if that be the case, will not change this conclusion. It is held, therefore, that the acceptance of an award by an agent for a principal constitutes a government contract even though the formal contract bears a date subsequent to November 11, 1918.[57] Contracts with the American Red Cross are considered government contracts.[58] The term "government contract" includes contracts relating to sales of standard goods and services at open market prices as well as those of a special nature,[59] and includes contracts made with the United States, even though not connected with the prosecution of the war.[60]

AMENDED GOVERNMENT CONTRACTS. A government contract entered into in 1917, amended as to some of its provisions in 1918, and further modified in 1919, is in effect the same contract as entered into in 1917 if the original contract has not been revoked or supplanted by a new contract.[61]

CONTRACTS UNDER THE NAVAL APPROPRIATION ACTS. Contracts entered into pursuant to the Naval Appropriation Acts of March 4, 1917, and July 1, 1918, if entered into between April 6, 1917, and November 11, 1918, are "government contracts," even though these acts by their terms made obligatory compliance with all orders placed by the President, and authorized the President to take immediate possession of a factory upon failure to comply, allowing such reasonable compensation as he should determine. Such contracts are not to be placed in a category different from other contracts merely because they were given under the authority of a statute providing a penalty for failure to comply therewith.[62]

[57] O. D. 540, T. B. 24-20-993.
[58] O. D. 261, T. B. 17-19-468.
[59] O. 916, T. B. 21-19-519.
[60] O. D. 677, T. B. 41-20-1228.
[61] O. D. 295, T. B. 24-19-557; O. D. 1063, T. B. 42-21-1867.
[62] O. D. 477, T. B. 17-20-889.

WHAT ARE NOT GOVERNMENT CONTRACTS. Contracts entered into between a taxpayer and the Knights of Columbus or the Young Men's Christian Association are not considered government contracts.[63] A contract entered into on May 1, 1918, with the Director-General of Railroads for certain cars for the account, use and benefit of various railroads under federal control is not "a government contract" for the reason that the cars are not for the use or for the account of the United States.[64] Sales of goods from existing stocks where delivery is immediate are not government contracts.[65]

SUBCONTRACTORS. A corporation which contracted with another corporation to manufacture and deliver machinery to be used in manufacturing ammunition, but did not produce or furnish ammunition or any component part thereof, nor perform any direct service in connection with the production of ammunition manufactured by another corporation under contract for the United States government, is not a subcontractor.[66] A subcontract entered into subsequent to November 11, 1918, based on a principal contract to furnish a product for the benefit of the United States entered into between April 6, 1917, and November 11, 1918, is held to constitute a government contract.[67]

GOLD-MINING CORPORATIONS. In the case of a corporation engaged in the mining of gold, that portion of its net income derived from the mining of gold is exempt from excess-profits tax. The tax on the remaining portion of its net income is computed in the following manner: The tax is first computed on the entire net income but only such proportion thereof as the proportion of net income derived from sources other than gold mining bears to the entire net income, is taken to be the amount due.[68]

Allocation of Net Income to Particular Source. In the case of corporations deriving income from government contracts, or from mining or from personal service trade or business, and in any other cases where it is necessary to determine the portion of the net income derived from or attributable to a particular source, the corporation is required to allocate to the gross income derived from such source, and to the gross in-

[63] O. D. 261, T. B. 17-19-468.

[64] O. D. 224, T. B. 12-19-394.

[65] O. 916, T. B. 21-19-519.

[66] O. D. 359, T. B. 2-20-666.

[67] O. D. 662, T. B. 38-20-1200.

[68] Revenue Act of 1921, § 304; Revenue Act of 1918, § 304. See illustration No. 6, appendix to 1920 edition.

come derived from each other source, the expenses, losses and other deductions properly appertaining thereto, and to apply any general expenses, losses and deductions (which can not properly be otherwise apportioned) ratably to the gross income from all sources. The gross income derived from a particular source, less the deductions properly appertaining thereto and less its proportion of any general deductions, is the net income derived from such source.[69] If exact determination of income arising from government contracts distinctly from other income is impossible, an approximation based on the proportion which sales to the government bears to other sales should be used only in case approximations based on the respective cost and selling price are inapplicable. The approximation should be based upon the allocation of costs and allocation of selling price, in the most accurate manner possible from available records. Amortization is not to be charged exclusively against income from government contracts, and selling and administrative expenses not applicable to the government contracts should not be so charged.[70] The corporation must submit with its return a statement fully explaining the manner in which such expenses, losses and deductions were allocated or distributed.

ADVERTISING EXPENSES. Advertising and sales promotion are not a part of the necessary expenses of government contracts, except as relating to such contracts, and are not proper deductions from the gross income derived from government sales. Such expenditures, if entered into on a large scale at a time when the government was doing practically no commercial business, may be treated either as an expense of the year in which incurred and deducted from the commercial income only, or they may be treated as deferred items in the balance sheet and set up as good will thereon, being in the nature of expenditures for the building up of future business and not for the business secured during the taxable year in which such expenditures were incurred.[71]

INVENTORIES OF GOVERNMENT CONTRACT MATERIAL. In so far as stock purchased for government contracts is used or useful for commercial purposes no separate inventory thereof need be made for government contract accounting, such inven-

69 Reg. 45, Art. 715.

70 A. R. M. 1, T. B. 26-19-597. See paragraph below on "Advertising Expenses."

71 O. D. 394, T. B. 5-20-721.

tories being treated as commercial inventories in the ordinary course at the close of the taxable year 1919. If, however, a portion of such goods purchased is useful only for government contracts and is still on hand at the close of the taxable year 1919, such goods should be inventoried at the then value if lower than cost and assigned to the government contract section of the income statement for that year.[72]

Taxable Year. The term "taxable year" means the calendar year or the fiscal year ending during such calendar year, upon the basis of which net income is computed for the purpose of the income tax. The first taxable year under the Revenue Act of 1918 was the calendar year 1918, or any fiscal year ending during the calendar year 1918. The first taxable year under the Revenue Act of 1921 is the calendar year 1921, or any fiscal year ending during the calendar year 1921.[73]

Fiscal Year. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.[74] If a corporation keeps its accounts on the basis of a fiscal year, the law requires that it report its income on that basis, and not at its option either on that basis or on the basis of the calendar year as was the rule formerly.[75]

Prewar Period. The term "prewar period" means the calendar years 1911, 1912 and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence. Thus, if a corporation was in existence during the entire year 1913, that year becomes its prewar period, but if in existence only a part of the year 1913, it is deemed to have no prewar period and becomes taxable under the provisions applying to corporations formed after the prewar period.[76]

Statement of the Tax. The tax imposed by Title III of the Revenue Act of 1921 is in lieu of the tax imposed by Title III of the Revenue Act of 1918, which was in lieu of the tax imposed

72 O. D. 394, T. B. 5-20-721.

73 Revenue Act of 1918, §§ 300, 200; Revenue Act of 1921, §§ 300, 200.

74 Revenue Acts of 1918 and 1921, §§ 300, 200.

75 Revenue Acts of 1918 and 1921, §§ 232, 212 (b) and 200.

76 Revenue Act of 1918, § 310; Reg. 41, Art 6. Under the 1917 Law the earnings of the pre-war period determined the amount of the excess-profits deduction, between the limits of 7% and 9% of the invested capital. Under the 1918 Law no reference was made to the pre-war period in ascertaining the excess-profits credit, since that credit is 8% of the invested capital regardless of the pre-war earnings. But the pre-war earnings and pre-war invested capital were used in computing the war-profits credit under the Revenue Act of 1918.

by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by the Revenue Act of 1918. The excess-profits tax imposed by the present law is likewise in addition to the other taxes imposed by the Revenue Act of 1921.[77] The war-profits and excess-profits tax is imposed upon the net income of every corporation, whether or not derived from a business or trade or from investment or otherwise.[78] Briefly stated, the excess-profits tax is computed on the entire net income of the taxable year after deducting the excess-profits credit, at the rates specified in the statute. For the taxable year 1918 the war-profits tax was computed on the entire net income in excess of the war-profits credit at the rate specified in the act, and whichever of the two taxes (the excess-profits or war-profits) was the greater was assessed. The rates of tax, net income, invested capital, excess-profits credit and war-profits credit are more fully discussed in the following paragraphs.

Rates of Tax for 1917. The rates of tax imposed by the 1917 Law are given in the introductory paragraph of this chapter.[79] The statute provided for the taxation of "the amount of the net income in excess of the deduction" at twenty per centum.[80]. This phrase was held by the Commissioner to mean that the first of the graduated percentages of invested capital (fifteen per centum) was first to be ascertained and that the deduction was to be made from the amount thereof; and if the deduction was not in excess of fifteen per centum of the invested capital, the difference between the amount of the deduction and the fifteen per centum of invested capital was to be taxed at twenty per centum. This construction has been sustained by the court in preference to the construction that the deduction was to be made from the whole of the net income, and that out of the balance of

77 Revenue Act of 1921, § 301 (a); Revenue Act of 1918, § 301 (a).

78 See Revenue Act of 1918, §§ 213 (a), 233 (a). Under the 1917 Law, in the case of a partnership or corporation, all income was deemed to be received from its trade or business, and the terms "trade," "business," and "trade or business" included all sources of income (Reg. 41, Art. 7). All trades or businesses engaged in by a corporation or partnership were treated as a single trade or business, and its entire income was deemed to be of the class of its principal trade or business (Reg. 41, Art. 14).

79 Some concerns were taxable at a flat rate of 8%. (See p. 1016.) As to the rates prescribed for the individual or concern not so taxable see Reg. 41, Arts. 14, 16, 17. As to the computation of the tax in the case of a partnership or corporation or partnership with a fiscal year ending in 1917, see Reg. 41, Art 19; and as to the computation of the tax for a period of less than 12 months, see Reg. 41, Art. 20.

80 See Revenue Act of 1917, § 201.

net income remaining an amount not in excess of fifteen per centum of the invested capital was to be taxed at twenty per centum.[81]

Rates of Tax for 1918. The rates of tax are stated in the form of three brackets as follows:[82] First bracket, 30% of the amount of net income in excess of the excess-profits credit and not in excess of 20% of the invested capital. If the excess-profits credit equalled or exceeded 20% of the invested capital, no tax was imposed under this bracket. The second bracket provided a rate of 65% of the amount of net income in excess of 20% of the invested capital. If, however, the excess-profits credit exceeded 20% of the invested capital, this rate was applied only to the amount of net income in excess of such excess-profits credit.[83] The third bracket provided that there should be added to the tax computed under the first and second brackets the sum, if any, by which 80% of the amount of net income in excess of the *war-profits credit* exceeded the amount of tax computed under the first and second brackets. As a practical matter, if 80% of the amount of net income in excess of the war-profits credit was greater than the tax computed under the first and second brackets, the 80% tax became the tax due from the corporation and the computation under the first and second brackets might be disregarded.[84]

Rates of Tax for 1919, 1920 and 1921. In the case of all corporations other than those referred to in the following paragraphs, the rates for 1919 and subsequent years computed under the first bracket as above indicated are 20% instead of 30% and under the second bracket are 40% instead of 65%. No tax is imposed under the third bracket.[85]

81 Ehret Magnesia Co. v. Lederer, 273 Fed. 689; T. D. 3200, T. B. 32-21-1764; Greenport Basin Co. v. U. S., 269 Fed. 58; T. D. 3137, T. B. 14-21-1556.

82 Revenue Act of 1918, § 301 (a).

83 Revenue Act of 1918, § 301 (d). See illustration No. 2, appendix to 1920 edition.

84 This device of adding the excess amount of the war-profits tax over the excess-profits tax to such excess-profits tax was invented by the senate to overcome the objection to the provision in the bill as originally drafted, which expressly provided for an alternative excess-profits or war-profits tax, the larger of the two being the amount assessed. The change made by the Senate did not in substance change the tax and it was still a tax computed by two alternative methods, the one productive of the greater amount of revenue being applied to the taxpayer.

85 Revenue Act of 1918, § 301 (b); Revenue Act of 1921, § 301. See illustration No. 1, appendix to 1920 edition.

Fiscal Year Ending in 1919. If a corporation makes a return for a fiscal year beginning in 1918 and ending in 1919 the tax for such fiscal year is determined as follows: The amount of tax for the entire fiscal year computed at the 1918 rates is first determined and such proportion thereof as the part of the fiscal year falling in 1918 bears to the entire fiscal year is assessed as a portion of the tax. Similarly the 1919 rates are applied to the entire net income for the fiscal year and such portion assessed as the proportion of the fiscal year in 1919 bears to the full fiscal year.[86] The sum of the two portions thus ascertained is the tax for the fiscal year.

Fiscal Year Ending in 1921. Since the excess-profits tax is imposed upon the net income as computed for the purpose of the income tax and the Revenue Acts of 1918 and 1921 contain different provisions regarding what constitutes gross income and allowable deductions, it is necessary to provide a special rule for the computation of the excess-profits tax of a corporation (other than a personal service corporation) making a return for the fiscal year beginning in 1920 and ending in 1921. The tax of such a corporation for the taxable year 1920 consists of the sum of (1) the same proportion of the tax for the entire period computed under the Revenue Act of 1918 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of the tax for the entire period computed under the Revenue Act of 1921 which the portion of such period falling within the calendar year 1921 is of the entire period. Any amount paid on account of the tax imposed for such taxable year by the Revenue Act of 1918 will be credited towards the payment of the tax as above computed,

[86] Revenue Act of 1918, § 335 (b); illustration No. 8, appendix to 1920 edition. The same principles governed the computation of the tax for a corporation with a fiscal year beginning in 1917 and ending in 1918. (Revenue Act of 1918, § 335.) Any amount paid on account of the tax imposed for such fiscal year by the Revenue Act of 1917, was to be credited toward the payment of the tax so computed, and if the amount so paid exceeded the amount of tax so computed, the excess was to be credited or refunded to the corporation. In cases in which corporations whose fiscal years ended in 1918, filed a return and paid the tax for the full fiscal year under the provisions of the Revenue Act of 1917, the tax was to be recomputed in the manner indicated and from the amount so found to be due there was deducted the amount of excess-profits tax paid on the basis of the full fiscal year. It followed that the income tax for the same period must also be computed according to the rule in § 205 (a) of the 1918 Law. after having deducted the excess-profits taxes as recomputed.

and if in excess of such tax as above computed, such excess will be credited or refunded to the taxpayer.[87]

Fiscal Year Ending in 1922. Except in the case of a personal service corporation the Revenue Act of 1921 makes provision for the case of a corporation making a return for a fiscal year ending in 1922 for the reason that the excess-profits tax is repealed as of December 31, 1921. The war-profits and excess-profits taxes for the portion of such fiscal year falling within the calendar year 1921 consists of an amount equivalent to the same proportion of the tax for the entire period computed under Title III of the Revenue Act of 1921 which the portion of such period falling within the calendar year 1921 is of the entire period.[88]

Corporations Deriving Income From Government Contracts. For the taxable year 1919, and each taxable year thereafter, the rates to be applied to corporations which derive in such year a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, are determined as follows: (1) the tax will be computed at the 1918 rates on the entire net income of the corporation, in the computation of which the excess-profits credit and war-profits credit applicable to the taxable year [89] will be used, and (2) the tax will also be computed on the entire net income of the taxable year at the 1919 rates. The sum of (a) such portion of the tax computed under (1) as the net income attributable to such government contract or contracts bears to the entire net income and (b) such portion of the tax computed under (2) as the part of net income not attributable to such government contract or contracts bears to the entire income will be the amount to be paid by the corporation.[90] The method of computing the tax is illustrated below.[91] In the case of a fiscal year corporation this computation should be based

[87] Revenue Act of 1921, § 335 (a). This provision is in accordance with the principles governing computation of taxes in the case of a corporation with a fiscal year ending in 1918 and in 1919 (See Revenue Act of 1918, § 335).

[88] Revenue Act of 1921, § 335 (b). Since personal service corporations are exempt from excess-profits tax of the year 1921, and are abolished as of the end of that year, no provision is necessary for the computation of the tax of personal service corporations with fiscal years ending in 1922.

[89] O. D. 378, T. B. 3-20-695.

[90] Revenue Act of 1918, § 301 (c); Revenue Act of 1921, § 301 (b). See p. 1030 for rule as to allocation of income.

[91] See illustration No. 4, appendix to 1920 edition.

on the entire net income for the fiscal year even though no part of the income from government contracts was derived after January 1, 1919. It is a fundamental principle that no adjustment will be made even though it can be definitely shown what proportion of the income was derived during each portion of the fiscal year.[92] If a corporation has a net income from a government contract and sustains a net loss from other operations, in the submission of a fiscal year return for a period ending in 1919 the loss may be deducted from the income from the government contract.[93]

Maximum Limit of Tax. The Revenue Act of 1918 for the first time fixes a maximum limit of tax. In no case will the tax imposed on the net income for the taxable year 1919 or subsequent years, be more than 20% of the amount of net income in excess of $3,000 and not in excess of $20,000, plus 40% of the amount of net income in excess of $20,000. On income of the year 1918 the maximum was 30% of the amount of net income in excess of $3,000 and not in excess of $20,000, plus 80% of the amount of net income in excess of $20,000. In the case of corporations deriving more than $10,000 of net income from government contracts in 1919 or subsequent years, these limits will apply to the respective amounts of tax computed under the 1918 and 1919 rates, by reason of the provision taxing 1919 income from government contracts at 1918 rates. Thus, on that part of the net income derived from government contracts the maximum limit of 30% and 80% will apply while to that not derived from government contracts the maximum limit of 20% and 40% will apply. This limit is not intended to increase the tax but to reduce it in cases where the tax calculated in the ordinary manner is greater than the maximum computed according to the rule stated in this paragraph.[94] The limitation will generally operate only in the case of corporations with very small invested capital.[95] It is applied to the

[92] T. B. M. 4, T. B. 1-19-113.

[93] A. R. M. 5, T. B. 26-19-620.

[94] Revenue Act of 1918, § 302; Revenue Act of 1921, § 302. See illustration in Art. 733 of Reg. 45, as amended by T. D. 3245, T. B. 48-21-1953. In calculating this maximum limit it is to be noted that foreign corporations receive the benefit of a specific exemption of $3,000, even though they are not accorded such exemption ordinarily (Revenue Act of 1918, § 312; O. D. 402, T. B. 6-20-735). This conclusion is rendered inescapable by the use of the words "in no case" in § 302.

[95] An invested capital of less than $71,428.58.

consolidated net income of affiliated corporations and may not be construed to apply separately to the net income of each unit included in the return.[96]

LIMITATION WHEN RETURN FOR FRACTIONAL PART OF YEAR. When a return is rendered for a fractional part of a year, the limitation is to be computed in the same manner as if the period covered by the return were a full taxable year.[97]

Sale of Mines, Oil or Gas Wells. In the case of a *bona fide* sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the war-profits and excess-profits tax attributable to such sale cannot exceed 20% of the selling price of such property or interest.[98] To apply this provision to a particular case the corporation should compute the war-profits and excess-profits taxes in the ordinary way upon its net income, including its net income from any such sale. The proportion of the total tax indicated by the ratio which the taxpayer's net income from the sale of the property, allocated to such source by the proper method,[99] bears to its total net income is the portion of the tax attributable to such sale, and if it exceeds 20% of the selling price of the property, such portion of the tax will be reduced to 20% of such selling price.[100] The fact that a company is entitled to the benefit of this limitation will not disqualify it for special assessment by reference to representative corporations,[101] neither can the fact that it is entitled to the benefit of the limitation be used as a basis for claiming special assessment. If a corporation falls within the class specified in the statute as being entitled to special assessment, the tax will be determined by this method. The

[96] O. D. 80, T. B. 1-19-115.

[97] Reg. 45, Arts. 732, 733, as amended by T. D. 3245, T. B. 48-21-1953. The latter article gives an illustration of this computation.

[98] Revenue Act of 1921, § 337; Revenue Act of 1918, § 337. This limitation cannot be applied to the assessment of 1917 taxes (T. B. M. 60, T. B. 15-19-454).

[99] See Reg. 45, Art. 715. See p. 1030.

[100] Reg. 45, Art. 971. See illustration No. 7, appendix to 1920 edition. It will be noted that the government ruling requires the total tax to be apportioned for the purpose of applying the limitation. The statute provides that the "portion" of the tax attributable to such sale shall not exceed 20% of the selling price, and the difference between the amount of tax computed on the total income and the amount computed on the income excluding the profit on the sale seems intended by the law to be the amount which shall not exceed 20% of the selling price.

[101] See Revenue Acts of 1918 and 1921, §§ 327-8.

effect of the limitation is to limit the amount of tax attributable to the profit made on the sale of mines, oil and gas wells discovered by the taxpayer and can only be applied after the tax computed on such profit has been computed without the benefit of this provision.[102]

Invested Capital for 1917. The invested capital of a taxpayer for 1917 was determined in large part in the same manner as invested capital for 1918, as outlined in the paragraphs following. Where differences as to the method of computing invested capital existed, they are pointed out in connection with the statement of the 1918 rule.[103] The chief difference between the two statutes was occasioned by the fact that the 1917 Law taxed individuals and partnerships while the 1918 Law and the present law does not. The invested capital of partnerships was computed, however, under the 1917 Law under the same regulations which governed the computation of the invested capital of corporations.[104] Rulings particularly applicable to the computation of invested capital of individuals under the 1917 Law are indicated below.

The invested capital of individuals consisted of the total of: (1) actual cash paid into the trade or business; (2) tangible property paid into the trade or business, and (3) intangible property paid into the trade or business.[105] Subject to the making of an adequate allowance for depreciation, obsolescence and depletion, tangible property was valued according to the following rules:

In the case of tangible property purchased with cash, the valuation will be based upon the cost (estimated if not known) in cash at the time purchased.

In the case of tangible property paid in as such prior to January 1, 1914, the valuation will be based upon its actual cash value as of that date. Adequate evidence of such value must be furnished by the taxpayer.

[102] O. D. 395, T. B. 5-20-723; T. B. M. 60, T. B. 15-19-454.

[103] Cf. Revenue Act of 1918, § 326; Revenue Act of 1917, § 207.

[104] Reg. 41, Arts. 53, 65. See Revenue Act of 1917, § 207. It has been held under the Revenue Act of 1917 that stocks owned by individual partners could not be recognized as invested capital of the partnership even though purchased from profits distributed by the partnership and purchased for the purpose of advancing the interests of the partnership. (A. R. R. 17, T. B. 3-20-696; A. R. R. 619, T. B. 39-21-1848.)

[105] Reg. 41, Art. 66.

In the case of tangible property paid in on or after January 1, 1914, the valuation will be based upon its actual cash value at the time of payment.[106]

The 20% limitation based upon capital was, of course, not applied to individuals in the case of intangible property. Such property might be included in invested capital at a value not exceeding the cash paid therefor, or the cash value at the time of payment of tangible property paid therefor, but only if *bona fide* payment was specifically made therefor.[107]

Profits earned during the taxable year might be included in the invested capital of individuals, and were deemed to have arisen ratably throughout the year. The capital at the beginning of the year was increased by the total amount of such profits remaining in the trade or business averaged monthly over the year.[108]

Where an individual kept books of account, his invested capital was found in his capital account (under whatever name it might be called) after making therein any required adjustments or corrections, provided the assets other than those not allowed to be included equaled or exceeded the amount of such capital account. Otherwise the invested capital was the amount of such assets.

Where an individual did not keep books of account he was required to prepare and preserve a statement as at the beginning of the taxable year and as at the end of the taxable year, showing in full all his assets valued in accordance with the rules stated above, and all his liabilities. The excess of such assets over such liabilities at the beginning of the year and again at the end of the year constituted the invested capital of the individual on those dates, respectively, provided that in each case the assets other than those not allowed to be included equaled or exceeded the amount of such excess. Otherwise, the invested capital was the amount of such assets. The amount of the difference between the capital thus shown as at the beginning of the year and at the end of the year, in the absence of evidence to the contrary, was deemed to have arisen ratably throughout the year, and the capital at the beginning of the year was increased

[106] Reg. 41, Art. 67. The presumption was that tangible assets employed in the trade or business were acquired with cash derived from earnings, but the taxpayer was entitled to show that such assets were paid in as tangible property.

[107] Reg. 41, Art. 68.

[108] Reg. 41, Art. 69.

or decreased, as the case might be, by such amount averaged monthly over the year.

If an individual was engaged in more than one trade or business having invested capital, then his invested capital for the purposes of computing the deduction and applying the rates of taxation was determined by taking the total invested capital of all such trades or businesses.[109]

VALUE OF PROPERTY AS OF JANUARY 1, 1914. Under the 1917 Law the value of *tangible* property as of January 1, 1914, could be taken in the case where such property had been paid in for stock or shares prior to that date, but not in excess of the par value of the stock or shares. No such provision appears in the 1918 Law and the value must in all cases be determined as of the time of acquisition.[110]

Invested Capital for 1918, 1919, 1920 and 1921.[111] "Invested capital" is the value of the capital and surplus of the taxpayer determined in accordance with rules laid down in the statute. It does not mean the par value of the issued and outstanding stock or the value of the capital stock as fixed by the treasury department for the purpose of the capital stock tax. It does not mean the book value of the assets, or the present net worth of the assets as shown by an appraisal or in any other manner.[112] Generally speaking, it means the amount of cash or the cash value of the property contributed to the corporation by the stockholders and the amount of earnings of the corporation which have been left in the business. Money or other property borrowed is not invested capital.[113] The cash value of the property contributed by the stockholders to the corporation may in some cases exceed the value allowed by the law for purposes of invested capital, since the restrictive rules of the statute limit the inclusion in invested capital of capital stock representing intangible property. Further, capital may be contributed to the business of a corporation in a form originally permitting its inclusion in invested capital at its full value (cash, for instance)

109 Reg. 41, Art. 70. The terms "assets" and "liabilities", as used above, related only to assets or liabilities of the trade or business.

110 Cf. Revenue Act of 1917, § 207 and Revenue Act of 1918, § 326. See Reg. 41, Art. 55; O. D. 89, T. B. 1-19-128; A. R. R. 376, T. B. 5-21-1423; A. R. R. 337, T. B. 50-20-1347; O. D. 1097, T. B. 45-21-1916.

111 As to affiliated corporations see p. 1132.

112 Reg. 45, Art. 831. See La Belle Iron Works v. U. S., 41 Sup. Ct. Rep. 528, 65 L. Ed. 604; T. B. 23-21-1680. This case is fully reviewed on p. 1087. See also Reg. 41, Art. 42.

113 Reg. 45, Art. 831.

but may lose some of its value for purposes of invested capital by being invested in stocks of other corporations (the dividends of which are not included in net income)[114] or by being invested in state, municipal or other bonds, the interest on which is exempt from income tax. In this respect the law makes an exception of bonds or other obligations of the United States, which may be included in invested capital although the interest therefrom may in some cases be excluded from gross income.[115] Surplus and undivided profits are recognized as part of invested capital, if they represent assets actually existing and owned by the corporation.[116] Rentals on the property of a corporation charged while the property is used for construction work of the corporation are mere bookkeeping entries and may not be included in invested capital.[117]

The amount of taxes withheld at the source to be later paid over to the government is not an asset of the withholding agent and cannot be included in invested capital.[118] The surplus and undivided profits accounts may be reduced below the amounts at which they are carried on the books, if full recognition has not been given by the corporation to expenses incurred and losses sustained from the original organization down to the taxable year, including among such expenses and losses a reasonable allowance for depletion, depreciation or obsolescence of property originally acquired for cash or stock, or in any other manner. The value of the assets of the company are required in all instances to be taken as of the time of acquisition, although they may have increased in value since that date.

In a case in which the charter of a Georgia corporation expired by limitation and some time after its expiration, the fact being called to the stockholders' attention, a new corporation was organized, which new corporation issued new shares of capital stock in exchange for all the property and assets and all the interest of the stockholders in the old company, it has been held under the Georgia statutes that for purposes of in-

[114] Reg. 45, Art. 815.

[115] The purpose of permitting bonds of the United States to be included in invested capital, although the interest may be excluded in whole or in part from gross income, is to provide an incentive to invest in and hold such bonds.

[116] Reg. 41, Art. 42. A corporation may not report its income on a cash receipts and disbursements basis and compute its invested capital on an accrual basis (O. D. 1007, T. B. 34-21-1787).

[117] O. D. 811, T. B. 7-21-1453; O. D. 1061, T. B. 41-21-1862.

[118] O. D. 202, T. B. 9-19-350.

vested capital a new and distinct corporation was created, the invested capital of which should be computed accordingly.[119]

The fair market value of the assets as of March 1, 1913, has no bearing on invested capital.[120] If values have been marked up on the books of the corporation a deduction must be made in respect of such book appreciation. Full effect must also be given to any liquidation of original capital at any time prior to or during the taxable year.[121] In the case of a reorganization, consolidation or change of ownership of a trade or business after January 1, 1911, the invested capital of the predecessor for the prewar period is deemed to be the invested capital for such period of the new organization now engaged in the business. In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property after March 3, 1917 (if 50% or more of the interest or control remains in the same persons), the assets so transferred will not be allowed a higher valuation in determining invested capital than under the previous ownership. If the previous owner was not a corporation, the value of the assets in the hands of the present owner will be taken at the cost to the previous owner when acquired by him. The law contemplates that the invested capital shall be the average amount employed for a full year and if a corporation makes a return for a period less than twelve months the invested capital must be prorated accordingly. Thus although a corporation actually had an invested capital of $100,000 and was in existence for six months of the year 1918, for the purpose of this tax its invested capital would be considered as being only $50,000.[122] With respect to the value to be placed upon the several classes of assets of a corporation, such assets are divided into three clasess: (1) cash

119 A. R. R. 268, T. B. 41-20-1238. See Terry v. Merchants & P. Bk., 66 Ga. 177; Logan v. W. A. R. Co., 87 Ga. 533, 13 S. E. 516; Bertram v. Collins Mfg. Co., 69 Ga. 751; Rau v. Union Paper Mill Co., 95 Ga. 208, 22 S. E. 146; Venable v. Southern Granite Co., 135 Ga. 508, 69 S. E. 822; Stearns Coal Co. v. Van Winkle, 221 Fed. 590; Pewabic Min. Co. v. Mason, 145 U. S. 349, 12 Sup. Ct. 887.

120 Reg. 45, Art. 831.

121 See Reg. 41, Art. 42.

122 See letter from treasury department dated March 20, 1918; W. T. S. 1919, ¶ 764. This amounts to an assumption that if the corporation had been in business for the full year it would have earned twice the amount it did during the six months period. If it can be shown that by the very nature of its business no more income would have been earned had the corporation been in existence for the full year, it would seem that the case is one for remedial action under § 327. See p. 1116.

paid in; (2) tangible property paid in, and (3) intangible property paid in. Regardless of the character of the asset when paid in a further distinction is made with respect to the character of the asset during the taxable year. For this purpose the assets are divided into two classes: (1) admissible assets, and (2) inadmissible assets. The several classes and the adjustments required to be made with respect to each and to all as a whole are discussed in the following paragraphs.

No Par Value Stock. The par value of stock or shares in the case of stock or shares issued at a nominal value or having no par value is deemed to be the fair market value as of the date said stock or shares are issued.[123]

Cash Paid In. The amount of cash paid to a corporation in exchange for its stock is invested capital and remains such whether used for the purpose of acquiring tangible or intangible property.[124] Amounts paid in for stock become invested capital when the cash is actually received and not when stock, which is paid for in installments, is issued.[125] Thus, if the stockholders of a corporation have actually and in good faith paid in cash for its stock, such cash may be used to purchase good will, patents, copyrights, trade-marks or trade brands, and the intangible assets so acquired may be included in invested capital to the extent of their cost. It is only when such intangible assets are acquired in exchange for stock that the restrictive provisions of the statute limiting the amount of intangible assets which may be included in invested capital apply. If, however, the cash is used to acquire inadmissible assets, the invested capital will be reduced accordingly. But if the vendors of the property retain an interest or control of 50% or more in the property and it was transferred after March 3, 1917, the value for invested capital is limited as indicated below, whether the property is tangible or intangible.[126]

Stock Sold at a Discount—Brokers' Commissions. Reasonable commissions or other forms of compensation lawfully paid by the corporation for the sale of its capital stock are not to be deducted in computing invested capital.[127]

123 Revenue Acts of 1918 and 1921, § 325. The same principle has been followed under the 1917 Law (T. B. R. 38, T. B. 11-19-390; A. R. R. 520, T. B. 44-21-1893). See O. D. 348, T. B. 30-19-644.

124 Revenue Acts of 1918 and 1921, § 326 (a).

125 O. D. 991, T. B. 32-21-1765.

126 See Revenue Acts of 1918 and 1921, § 331. See p. 1053.

127 T. B. R. 4, T. B. 11-19-391 overruling a letter from the Treasury Department dated April 14, 1919; W. T. S. 1919, ¶ 1041. This rule is a

BONUS STOCK. Capital stock issued as a bonus in connection with the sale of a corporation's bonds may not be included in invested capital, unless the corporation proves to the satisfaction of the Commissioner that such stock bonus enabled the corporation to secure a higher price for the bonds than it could otherwise have secured. Whenever this fact is established, bonus stock may be included in invested capital to the extent of the difference between the selling price of the bonds and the price at which they could have been sold if issued without such stock bonus. The excess of the face value of such bonds over the price at which they could have been sold if issued without the stock bonus is deemed discount and is subject to amortization.[128]

STOCK ISSUED FOR SERVICES. Shares of stock distributed by a corporation to its employees in payment of services rendered, where the amount is not excessive, may be included in invested capital to the extent of the actual cash value of the services rendered.[129]

Tangible Property Paid In. When stock or shares have been issued for tangible property, the actual cash value of the tangible property at the time it is paid in becomes invested capital.[130] If the actual cash value of such tangible property exceeds the par value of the stock issued therefor,[131] the excess over the par value may be treated as paid-in surplus, provided it is shown to the satisfaction of the Commissioner that the value of the property was clearly and substantially in excess of the par value of the stock. Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment, and may consist among other things of (a) an appraisal of the property by disinterested authorities made on or about the

corollary of the rule that such commissions may not be deducted in computing net income. See Chapter 22.

128 Reg. 45, Art. 832.

129 O. D. 248, T. B. 13-19-431.

130 While the fact that a company may have defective accounting records, and can not accurately compute its invested capital, may under certain circumstances justify an assessment under § 210 of the Revenue Act of 1917, or § 328 of the Revenue Acts of 1918 and 1921, it does not permit valuation of assets as at a time subsequent to the date on which they were paid in for stock for computing invested capital. The assets of a corporation can not be valued as of March 1, 1913, for the purpose of computing invested capital. (T. B. M. 57, T. B. 14-19-440.)

131 The par value of stock or shares, in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued (Revenue Acts of 1918 and 1921, § 325).

date of the transaction; (b) certification of the assessed value in the case of real estate; and (c) proof of a market price in excess of the par value of the stock or shares. The additional value allowed in any case is confined to the value definitely known or accurately ascertainable at the time of the payment. No claim will be allowed for a paid-in surplus in a case in which the additional value has been developed or ascertained subsequently to the date on which the property was paid in to the corporation, or in respect of property which the stockholders or their agents on or shortly before the date of such payment acquired at a bargain price, as for instance, at a receiver's sale. Generally, allowable claims of this character will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation, and in all cases the proof of value must be clear and explicit.[132] It need not consist of an appraisal made on the date of acquisition, but the evidence must be "as of" that date, that is, in the light only of knowledge or facts ascertainable on that date and not in the light of subsequent happenings.[133] The following rulings have also been made as to the extent to which a paid-in surplus may be claimed:

(1) Where a corporation is one of the parties to a contract, it cannot be held to be paid-in surplus. Contracts which may be regarded as tangible assets can only constitute paid-in sur-

[132] Reg. 45, Art. 836; A. R. R. 390, T. B. 9-21-1487. In 1917 the rule was: Where it can be shown by evidence satisfactory to the Commissioner that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time. Evidence tending to support a claim for a paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares. (Reg. 41, Art. 63. See A. R. R. 161, T. B. 28-20-1064.) This ruling was supported by the language of the 1917 Law (§ 207 (a)) which permitted the inclusion of "the actual cash value of tangible property paid in * * * at the time of such payment."

[133] A. R. R. 161, T. B. 28-20-1064. It may not be reached by the empirical process of adjusting values reached several years later (A. R. R. 358, T. B. 2-21-1393). See Chapter 17 for a full discussion of the valuation of property.

plus, if they were made between outside parties and the rights of either of the parties is then transferred to a corporation without adequate consideration.[134]

(2) Where bondholders purchased at a foreclosure sale the property covered by the mortgage securing the bonds, and then transferred the property to a new corporation in exchange for its total authorized stock issue, the invested capital of the new corporation will be the value of the property as of the date of transfer to the corporation.[135]

(3) Where a corporation exchanges its stock for the assets of a partnership, which are greatly in excess of the par value of the stock, and there is no written obligation to the partners as to the payment of the excess, the taxpayer is entitled to submit evidence in support of a claim for paid-in surplus; however, if the corporation is obligated to the partners for any portion of the excess, a claim can not be sustained.[136]

(4) Where a corporation purchases for its own stock the property of another corporation (through a purchase of capital stock furthered by a merger) at a bargain as shown by an appraisal, it may not include the excess of the value over the purchase price in invested capital as paid-in surplus. Paid-in surplus does not contemplate an excess value of property purchased in a *bona fide* sale over the purchase price thereof.[137]

(5) A paid-in surplus may consist of claims against a corporation owed to and cancelled by creditor stockholders.[138]

RECORD TO BE KEPT. The Commissioner is required to keep a record of all cases in which tangible property is included in invested capital at a value in excess of the par value of the stock issued therefor, containing (a) the name and address of the taxpayer; (b) the business in which it is engaged; (c) the amount of invested capital and net income shown by the return; (d) the value of the tangible property at the time it was paid in; (e) the par value of the stock specifically issued therefor, and (f) the amount included as paid-in surplus. He is also required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress without regard to the restric-

134 A. R. R. 233, T. B. 40-20-1227.
135 T. B. R. 32, T. B. 8-19-334.
136 O. D. 249, T. B. 13-19-432.
137 O. D. 813, T. B. 7-21-1457.
138 A. R. R. 678, T. B. 47-21-1936.

tions ordinarily imposed on him with respect to making public the contents of tax returns.[139]

Definition of Tangible Property. The term "tangible property" means stocks, bonds, notes and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property.[140] A contract may be treated as tangible property only after the submission of a full statement as to its exact nature showing to the satisfaction of the Commissioner that it relates to rights in tangible property to such an extent that its value arises chiefly therefrom.[141]

EVIDENCES OF INDEBTEDNESS. Enforceable notes or other evidences of indebtedness, either interest bearing or non-interest bearing, of the subscriber received by a corporation upon a subscription for stock may be considered as tangible property in computing its invested capital to the extent of the actual cash value of such notes or other evidences of indebtedness at the time when paid in, but only (a) if such notes or evidences of indebtedness could under the laws of the jurisdiction in which the corporation was organized legally be received in payment for stock, and (b) if they were actually received by the corporation as absolute, and not as conditional, payment in whole or in part of the stock subscription.[142] Notes received from employees in payment of stock, title to which will revert to the corporation if the employee severs his connection with the corporation and to be paid out of earnings accruing on stock for which they are ostensibly given, while tangible property in a strict sense, add nothing to the resources of the corporation and are not "*bona fide* paid in" within the meaning of the statute. Even if an increase in working capital were achieved by the discounting of or borrowing on such notes, such increased capital would constitute borrowed capital which may not be included in invested capital.[143] Stock subscribed for by employees under an agreement permitting payments in cash, part cash and part deferred payments, or all deferred payments, subject to conditions that payment of sub-

139 Revenue Acts of 1918 and 1921, § 326 (a).

140 Revenue Acts of 1918 and 1921, § 325 (a). The 1917 Law contained no definition of tangible property, but the treasury department held that the term included stocks, bonds, bills and accounts receivable, notes and other evidence of indebtedness and leaseholds. (Reg. 41, Art. 47.)

141 Reg. 45, Art. 811.

142 Reg. 45, Art. 833.

143 S. 1391, T. B. 22-20-980.

scriptions should be in weekly installments; that deferred payment should bear interest; and that the agreement might be canceled either upon request of the employee, failure to make payments, any attempt of the purchaser to sell his stock or agreement, or resignation or dismissal of the employee prior to the expiration of five years; in the event of any cancellation the employee to receive the full amount of all payments with interest, and, dependent upon the time held more than one year, certain percentages of the difference between the subscription and market price of the stock; dividends to be credited to the subscriber's account as additional payments, except in case of cancellation, in which case the subscriber incurs no charge for interest upon deferred payments may be recognized as invested capital only in so far as the subscription payments have been actually received by the company.[144]

Intangible Property. Intangible property may be included in invested capital, when it has been acquired by direct purchase, at a value not in excess of the cash or the value of the tangible property specifically paid therefor.[145] It may be included in invested capital only to the extent permitted by the rules set forth in the following paragraphs, if paid for with stock or shares. Good will cannot be allowed as invested capital under a claim that a price paid to stockholders was in excess of the corporate book value of the stock, because such price was incident to a collateral transaction.[146] Earned surplus once acquired may be expended for intangible property without being subject to any limitation upon its inclusion in invested capital, provided the expenditure is properly capitalized. Thus, it has been held in the case of taxpayers engaged in the publication of newspapers, that moneys expended out of earned surplus or current earnings for the sole purpose of building up the circulation structure may be added to capital invested when proper proof of such expenditures is made and amended returns for prior years have been filed, and that the circulation structure so built up is intangible property.[147]

Definition. The term "intangible property means patents, copyrights, secret processes and formulae, good will, trade-

144 A. R. R. 10, T. B. 1-20-664.

145 See Reg. 41, Art. 60.

146 A. R. R. 413, T. B. 10-21-1502.

147 A. R. M. 141, T. B. 47-21-1937. See also A. R. R. 611, T. B. 32-21-1766.

marks, trade brands, franchises and other like property.[148] Most contracts are intangible property and in the absence of a specific ruling by the Commissioner to the contrary should be so regarded. Contracts relating to or representing rights in tangible property are regarded as tangible property [149] but only if *bona fide* paid in for stock or shares.[150] An unperformed contract to furnish manufactured products represents no rights in tangible property which would entitle it to be regarded as deriving its value chiefly therefrom. On the contrary, the value of the contract is of an intangible nature, contingent upon the performance of its terms and the realization of the anticipated profit.[151] Associated Press, and similar franchises, and subscription lists and mailing lists are intangible property.[152] The actual cash value of intangible property paid in for stock or shares must be determined in the light of the facts in each case.[153] Among the factors to be considered are (a) the earnings attributable to such intangible assets while in the hands of the predecessor owner; (b) the earnings of the corporation attributable to the intangible assets after the date of their acquisition; (c) representative sales of the stock of the corporation at or about the date of the acquisition of the intangible assets; and (d) any cash offers for the purchase of the business, including the intangible property, at or about the time of

148 Revenue Acts of 1918 and 1921, § 325 (a); A. R. R. 29, T. B. 9-20-776. In the 1917 Law patents were not defined as intangible property. (Revenue Act of 1917, § 207.) Under the 1917 Law the term "other intangible property" as used in § 207 was construed to mean property of a character similar to good will, trade-marks and the other specific kinds of property enumerated in the same clause. Property not clearly of such character might be held to be tangible within the meaning of the law. (Reg. 41, Art. 47.) Patents had a status intermediate between tangible and intangible property. (Reg. 41, Art. 56; T. B. M. 17, T. B. 3-19-208.) When acquired for stock their values must be determined in the light of their cost to incorporators just prior to incorporation (A. R. R. 396, T. B. 8-21-1471). It was held that patentable ideas and formulas—embryo patents—should be treated as patents already secured in A. R. R. 328, T. B. 48-20-1329.

149 Reg. 45, Art. 811.

150 O. D. 306, T. B. 24-19-578.

151 O. D. 635, T. B. 33-20-1140. In the case stated in this decision there would seem to have been a mixed aggregate of tangible and intangible property within the meaning of § 327.

152 Reg. 45, Art. 811.

153 See Chapter 17 for a full discussion of the valuation of intangible property.

its acquisition. A corporation claiming a value for intangible property paid in for stock or shares should file with its return a full statement of the facts relating to such valuation.[154]

It has been held that where a corporation controlled by a few individuals uses part of its profits to pay notes of its principal stockholders previously given as part of the purchase price of the stock of retiring stockholders, the amount of which notes being equal to the excess of the agreed price of such stock over its par or book value, such is not payment made *bona fide* specifically as such in cash or tangible property for good will or other intangible property, even though the retiring stockholders had in the contract of sale of stock agreed to refrain from entering into the business conducted by the corporation for a specified number of years.[155] In cases where stock has been issued for intangible property the following rules apply:

INTANGIBLE PROPERTY PAID IN PRIOR TO MARCH 3, 1917. Where intangible property was paid in prior to March 3, 1917, such intangible property becomes invested capital in an amount not exceeding (a) the actual cash value of the property at the time paid in, (b) the par value of the stock or shares issued therefor[156] or (c) in the aggregate 25% of the par value of the total stock or shares of the corporation outstanding on March 3, 1917,[157] whichever is the lowest.[158]

154 See Reg. 45, Art. 851. See Chapter 17.

155 In its recommendation the committee referred to the definitions of the term good will contained in the following cases: Boon v. Moss, 70 N. Y. 465; Lane v. Smythe, 46 N. J. Eq. 443, 19 Atl. 199; Crutwell v. Lye, 17 Ves. Jr. 335; Dodge Stationery Co. v. Dodge, 145 Cal. 380, 78 Pac. 879.

156 The par value of stock or shares in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued. (Revenue Acts of 1918 and 1921, § 325.)

157 Under the 1917 Law it was held that tangible property *bona fide* purchased prior to March 3, 1917, with stock having no par value could be included in invested capital at a value not exceeding the actual cash value of such intangible property at the time of the purchase or in an amount not exceeding 20% of the total shares of stock outstanding on March 3, 1917, measured by their value as at the date or dates of issue. (Reg. 41, Arts. 57, 58.)

158 Revenue Acts of 1918 and 1921, § 326 (a) 4, 5. In the case of a reorganization in which the capital stock is increased but the control of the business remains in the same hands the value of the stock issued for intangible property must be determined with reference to the capitalization of the old company and not the capitalization of the new company. (Letter from treasury department dated March 14, 1918.)

Illustration: assume the par value of the capital stock of a corporation issued and outstanding on February 1, 1917, was $100,000. On February 2, 1917, it issued an additional $100,000 par value of stock for intangible property having a cash value of $100,000. Applying the foregoing rule, (a) equals $100,000; (b) equals $100,000 and (c) equals 25% of $200,000 (the par value of the stock outstanding on March 3, 1917). Therefore (c), or $50,000, is all that may be considered as invested capital representing such intangible property. A further limitation on the inclusion in invested capital of capital stock representing intangible property paid in both before and after March 3, 1917, is discussed in a later paragraph.[159]

INTANGIBLE PROPERTY PAID IN ON OR AFTER MARCH 3, 1917, Where the intangible property was paid in after March 3, 1917, such intangible property becomes invested capital in an amount not exceeding (a) the actual cash value of the property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest.

Illustration: assume a corporation has $200,000 par value of capital stock outstanding on December 30, 1917. On December 31, 1917, it issues an additional $100,000 of capital stock for intangible property having a cash value of $100,000. Applying the foregoing rule: (a) equals $100,000; (b) equals $100,000, and for the taxable year 1918 (c) equals 25% of $300,000. Therefore, the invested capital representing such intangible property is $75,000. But if the same intangible property had been acquired on January 2, 1918, instead of December 31, 1917, the invested capital for 1918 representing the same value of intangible property would be only $50,000 instead of $75,000, since in that case the par value of the capital stock outstanding at the beginning of the taxable year would have been only $200,000.[160]

A further limitation on the inclusion in invested capital of capital stock representing intangible property paid in both before and after March 3, 1917, is discussed in the following paragraph.

WHERE INTANGIBLE PROPERTY HAS BEEN PAID IN BOTH BEFORE AND AFTER MARCH 3, 1917. Where intangible property has been paid into a corporation before and also after March 3, 1917, a further limitation is imposed upon the value

[159] See p. 1053.

[160] Revenue Acts of 1918 and 1921, § 326 (a) 4, 5.

of the invested capital to represent in the aggregate all such intangible property. The law provides that in no case shall the total amount of invested capital representing intangible property paid in both before and after that date exceed in the aggregate 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year.[161]

Illustration: assume the par value of the capital stock outstanding February 1, 1917, was $100,000 and that $100,000 additional was issued for intangible property of the same cash value on February 2, 1917, and a further issue of $100,000 par value on December 31, 1917, for intangible property also having an equal cash value. Applying the first and second rules stated in the preceding paragraphs it is found that the invested capital with respect to the first intangible property is $50,000 and with respect to the second intangible property is $75,000, making the total for both $125,000. But applying the third rule the total invested capital representing both the property acquired on February 2, 1917, and that acquired on December 31, 1917, is reduced in the aggregate to $75,000. If the second property had been acquired on January 2, 1918, instead of December 31, 1917, the invested capital representing both properties would be reduced even lower, namely to $50,000, which amount would then represent 25% of the par value of the capital stock of the corporation outstanding January 1, 1918.[162]

Stock or Shares Outstanding on March 3, 1917. Where since the organization of a corporation its capital stock has been increased or reduced and such change represents an actual acquisition of new property for stock or an actual impairment of original properties, the 25% limitation will be based on the par value of the total stock outstanding on March 3, 1917.[163]

No Paid-in Surplus as to Intangible Property. No paid-in surplus may be included in invested capital by reason of any excess in the actual value of intangible property at the date of acquisition over the par value of the stock or shares issued therefor. On the contrary, such intangible property is subject to the 25% limitation stated in the preceding paragraphs, whatever its actual value may be.[164]

161 Revenue Acts of 1918 and 1921, § 326 (a) 5.

162 As to affiliated corporations see p. 1132.

163 T. B. M. 5, T. B. 1-19-120.

164 A. R. M. 80, T. B. 37-20-1196; A. R. R. 307, T. B. 44-20-1282.

INTANGIBLE PROPERTY ACQUIRED FOR TANGIBLE PROPERTY. Intangible property when acquired for tangible property other than stock must be taken into account at the value of such intangible property at the date of acquisition. Such value is measured by the fair market value of the tangible property exchanged therefor at the date of the transaction and not by the original cost of such tangible property.[165]

Mixed Aggregates of Tangible and Intangible Property. The statute[166] provides that where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively, the corporation shall be assessed by reference to representative corporations engaged in a like or similar trade or business.[167] Where stock or shares and bonds or other obligations have been issued for a mixed aggregate of tangible and intangible property, it will be presumed in the absence of satisfactory evidence to the contrary that the bonds were issued for tangible property and that the stock was issued for the balance of the tangible property, if any, and for the intangible property. Where stock or shares have been issued for a mixed aggregate of tangible and intangible property and certain liabilities have been assumed in connection with the transaction, it will be presumed that such liabilities are to be charged against the tangible property and the intangible property in the order named unless it is shown by evidence satisfactory to the Commissioner that this presumption is not in accordance with the facts.[168] Where a

[165] A. R. M. 131, T. B. 25-21-1698. This ruling did not involve the question of appreciation because it was not the value of the tangible property itself which was written upon the books of the corporation. An exchange of the tangible property for a cash equivalent would have determined a profit over original cost. This profit would have been reflected in surplus. In a similar manner the excess of the value of the intangible property acquired over the cost of the tangible property given in exchange therefor was a proper credit to the surplus of the corporation. The determination of a current value had no relation to original cost because tangible property before and after transfer had an immediate realizable value. (See also Reg. 41, Art. 60.) See Chapter 17 for a discussion of the valuation of property.

[166] Revenue Acts of 1918 and 1921, § 327 (c).

[167] See Revenue Acts of 1918 and 1921, § 328.

[168] Reg. 45, Art. 835. Under the 1917 Law it was held that where stock or shares (or stock or shares and bonds or other obligations) have been issued for a mixed aggregate of: (a) tangible property, (b) patents and

mixed aggregate of tangible and intangible property is acquired for stock and no provision is made that the intangibles shall be specifically paid for as such, in order that such intangibles may be included in invested capital it is only necessary to show the relative values of the tangibles and intangibles for which stock was issued, subject to the 20% or 25% limitation.[169]

SURPLUS AND UNDIVIDED PROFITS OF FOREIGN BRANCH OFFICE. In order to determine the amount of surplus attributable to a foreign branch office the amounts remitted by it to the home office should be taken into earned surplus at their value in American currency at the time of the remittances, and the balance of the net profits of the branch office not remitted to the home office should be converted into American currency at the rate of exchange as at the end of the taxable year.[170]

Surplus and Undivided Profits. Paid-in or earned surplus and undivided profits at the beginning of the taxable year may be included as invested capital. Surplus and undivided profits earned during the year may not be included.[171] Appreciation in

copyrights, and (c) good will or other intangible property, the following rules would govern: (1) in the absence of satisfactory evidence to the contrary, it was presumed in the case of a corporation, that its stock was issued for the following purposes in the order named: (a) good will or other intangible property, (b) patents and copyrights, and (c) tangible property. (2) Upon the production by the taxpayer of evidence satisfactory to the Commissioner as to the actual values at the date of acquisition of (a) the tangible property and (b) the patents and copyrights, the sum of these two items could be applied against the total par value of the securities issued and the remainder was then deemed to represent the par value of the securities issued for the good will or other intangible property. (3) Cases where mixed aggregates of tangible and intangible property have been paid in for stock and bonds were, if the Commissioner was unable to determine satisfactorily the respective values of the several classes of property at the time of payment, treated as coming under the head of cases where the invested capital could not be satisfactorily ascertained and the tax was assessed accordingly. (Reg. 41, Art. 59; T. B. R. 49, T. B. 16-19-467; A. R. R. 459, T. B. 15-21-1568.)

169 A. R. M. 80, T. B. 37-20-1196. See A. R. R. 307, T. B. 44-20-1282.

170 O. D. 618, T. B. 31-20-1109; O. D. 550, T. B. 25-20-1009.

171 Revenue Acts of 1918 and 1921, § 326 (a). Under the 1917 Law some doubt existed as to whether or not surplus earned during the taxable year and actually employed in the business during a part of that year could not be included in invested capital. The treasury department ruled that it could not in the case of corporations and partnerships (Reg. 41, Art. 61) even though invested in bonds of the United States (T. D. 2541) or set up as "surplus" on the books or distributed in the form of stock dividends (Reg. 41, Art. 61) but that profits earned during the year could be included as invested capital of individuals (Id. Art. 69). The 1917 Law also provided that surplus or undivided profits in order to be included in

values due to reappraisement can not be regarded as paid-in or earned surplus,[172] even though income tax has been erroneously paid thereon.[173]

Replacement Fund. It was held under the 1918 Law that so much of a replacement fund for steamers lost as represents excess of the amount of insurance received over the book value of the steamers at the time of their destruction may not be included in invested capital for the purpose of war and excess-profits taxes, even though the interest received from the investment of such excess is reported as taxable income, because such excess is not "paid-in or earned surplus."[174]

Paid-in Surplus. Where it is shown by evidence satisfactory to the Commissioner that tangible property has been paid in by a stockholder [175] to a corporation as a gift or at a value definitely known or accurately ascertainable as of the date of such pay-

invested capital should be "used or employed in the business," but the distinction, if any exists, between assets used and assets not used in the business of a corporation was too fine for practical purposes, and since the law elsewhere provided that all the income of a corporation should be deemed to be received from its trade or business, the Treasury Department ruled that all surplus or undivided profits would be deemed to be employed in the business, unless invested in inadmissible assets (Id. Art. 62).

[172] A. R. R. 29, T. B. 9-20-776; A. R. R. 71, T. B. 18-20-906; letter from treasury department dated March 5, 1918.

[173] T. B. M. 41, T. B. 7-19-308.

[174] O. D. 417, T. B. 12-20-801. See also Reg. 45, Art. 50, and a discussion of replacement funds in Chapter 20, particularly the new provision in regard thereto in the Revenue Act of 1921, which differs from the previous practice of the department.

[175] The property must be paid in *by* a stockholder. A claim for paid-in surplus will not be allowed in the case of the appreciated value of a leasehold acquired by a company as original lessee without cost and which was not paid in at a fixed value for stock or shares (A. R. R. 86, T. B. 19-20-925). In a case arising under the 1917 Law two stockholders owning most of the stock of a company invented certain machinery for which patents were issued to them. The company paid the cost of the patents and used them as though it owned them without compensation to the inventors. In 1916 the patents were put upon the books of the company at a certain value and a stock dividend was declared. The committee held that, even assuming the patents not to have been formally assigned to the company until 1916, they were not paid for by the issuance of stock or by any payment of cash, for which reason the amount placed upon the corporate books as the value of the patents could not be included in invested capital (A. R. R. 9, T. B. 1-20-665). It is difficult to see why such patents should not be included in invested capital as paid-in surplus on the theory that they constituted tangible property (under the 1917 Law) paid in by stockholders as a gift. The stock dividend, in such event, merely capitalize the paid-in surplus.

ment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess will be deemed to be paid-in surplus. Substantially the same kind of evidence will be required to show the value in this case as is required in the case of tangible property paid in at a value greater than the par value of the shares issued therefor.[176]

OIL LEASES INFORMALLY TRANSFERRED TO CORPORATION. It is held that where certain commercial leases of oil lands are informally transferred to a corporation formed by the lessees for the purpose of taking over such leases, no consideration being paid for such transfer, it will be deemed that the transfer was made at the time of taking possession, and the addition to invested capital of the corporation upon such transfer is the fair market price or value of the leases at the time possession is so taken by the corporation.[177]

EARNED SURPLUS.[178] Only true earned surplus and undivided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. Any portion of surplus or undivided profits representing unearned interest or discount which has not been reported as taxable income must be excluded in the computation of invested capital for war profits and excess-profits purposes.[179] In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence, or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses, or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of

176 Reg. 45, Art. 837.
177 S. 1387, T. B. 21-20-965.
178 This subject is more fully discussed on p. 1080.
179 O. D. 91, T. B. 1-19-130.

any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed.[180] Unrealized appreciation in the value of assets can not be taken into consideration for the purpose of offsetting a decrease by reason of depreciation, obsolescence or depletion.[181]

INSTALLMENT SALES. If a taxpayer reports profits on installment sales on the basis of the proportionate part of each installment received representing profit, his surplus account as at the beginning of the taxable year must be reduced in computing invested capital to the extent that the surplus account includes profit on such sales which has not been reported as taxable income.[182] Where a corporation changes its method of reporting the profit from installment sales from the basis of reporting the entire profit at the date of the sale to the basis of reporting the profit as being realized as at the date of the collection of the outstanding accounts, any part of the unliquidated installment sales contracts at the date the new basis is adopted is to be carried to accounts receivable on the balance sheet at the beginning of the taxable year in which the change is made. But this does not require the corporation to exclude from surplus any amount represented by such contracts which has already been returned as income for the prior years.[183]

PURCHASE OF STOCK WITH CASH AND PATENTS. Where a domestic corporation exchanges patent rights and cash for stock in a foreign corporation which derives no income from sources within the United States, the shares of stock so received constituted admissible assets under the 1918 Law.[184] Such stock was to be valued in determining the invested capital of the domestic corporation under the 1918 Law at the amount of cash paid therefor, plus the value of the patent rights at the time of the purchase, such value not to be taken as exceeding the value of the shares of stock received in exchange for the patent rights. The effect of the transaction might be to increase or decrease the surplus and undivided profits of the domestic corporation though the cash and patent rights remain the same. Such increase or decrease was due to such a change in the situation as amounted to a realization of gain or loss. Any gain so realized was earned surplus; as any loss so realized effected a

[180] Reg. 45, Art. 838.
[181] A. R. R. 71, T. B. 18-20-906.
[182] O. D. 92, T. B. 1-19-131.
[183] O. D. 793, T. B. 6-21-1428.
[184] For the rule under the present law see p. 1076.

decrease in earned surplus. In determining invested capital, earned surplus was considered regardless of the time when earned, and it is therefore immaterial that the gain or loss realized from the transaction was due to appreciation or depreciation which in part occurred prior to March 1, 1913.[185]

Reserves. The amounts shown on the balance sheet as reserves may or may not be included as invested capital according to the character of the reserve.[186] Some reserves are merely subdivisions of the surplus account and are true surplus or undivided profits. Such reserves are, for instance, reserves for bad debts, reserves for contingencies, reserves for self-insurance, and reserves for federal income and excess-profits tax. Any reserve the additions to which can not be deducted as an expense in the return of income, may be considered as a part of the surplus and undivided profits for the purpose of invested capital. On the other hand, with perhaps only two exceptions, reserves, the additions to which may be deducted in ascertaining net income, can not be included as invested capital. Among such reserves are reserves for depreciation (which are presumed to offset the loss in the assets) and reserves for state or local taxes in cases where the corporation reports on an accrual basis and the amounts carried to such reserves have been deducted. An exception to this general rule would appear to exist in the case of reserves for depreciation or depletion based upon the value of the property as of March 1, 1913, or in the case of depletion

185 T. B. R. 67, T. B. 22-19-538. In this respect the principles applicable to the determination of invested capital differ from those applicable to the computation of taxable income, for while such part of the realized appreciation, if any, as is attributable to the period after March 1, 1913, constitutes taxable income such part as is attributable to the period before March 1, 1913, though considered in the computation of invested capital, escapes taxation.

186 "Reserves" have been variously classified by accountants. They are classified by Mr. Esquerré in "Applied Theory of Accounts" as follows: "1. Reserves for depreciation; 2. operating reserves; 3. reserves for surplus contingencies; 4. reserves for redemption of debt; 5. secret reserves; and 6. reserves for exhaustion of physical assets." Reserves are classified by Mr. Hatfield in "Modern Accounting" as follows: "1. reserves created to provide a permanent increase of capital. (a) as an additional guaranty to creditors, (b) to provide for extension of its fixed or other assets; 2. reserves created to provide an additional capital which can be used to cover unusual losses or to provide for other emergencies without encroaching on the nominal capital; 3. reserves created to provide for equalizing dividends by retaining part of one year's profit to be used to make up scanty profits for other years."

based on the value of a mine or oil or gas property thirty days after discovery. These exceptional cases are referred to in the following paragraphs.

RESERVES FOR TAXES. Reserves set aside out of surplus or undivided profits of preceding years for payment of federal taxes or state taxes not yet due can be included in invested capital for the taxable year if, and to the extent that, such taxes were not allowable deductions in computing net income for the preceding taxable years. Inasmuch as federal income and excess-profits taxes are not deductible in computing net income subject to such taxes, reserves set aside for the payment of such taxes may be included in invested capital.[187] But amounts payable on account of income and excess-profits taxes for any year may be included in computing the surplus and undivided profits for the succeeding year only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates on which such taxes become due and payable.[188] A deduction from the invested capital as of the beginning of the taxable year must therefore be made for such taxes or any installment thereof, averaged for the proportionate part of the taxable year after the date when the tax or the installment is due and payable. Where as a result of an audit by the Commissioner, or the acceptance of an amended return, or for any other reason, the amount of any such tax for the preceding year is subsequently changed, a corresponding adjustment will be made in the invested capital for the taxable year upon the same basis as if the corrected amount of the tax for the preceding year had been used in the original computation of the invested capital for the taxable year.[189]

RESERVE FOR DEPRECIATION OR DEPLETION. If any reserves for depreciation or for depletion are included in the surplus account it should be analyzed so as to separate such reserves and leave only *real surplus*. Reserves for depreciation or depletion

[187] Letter from treasury department dated March 20, 1918; W. T. S. 1918, ¶ 911.

[188] Reg. 45, Art. 845; T. D. 2791. Prior to this treasury decision it was uncertain whether or not a corporation which indicated on its books of account that the excess-profits tax imposed on the income for 1917 was paid out of the earnings of 1918 need reduce its invested capital by reason of such payments. It was argued that the corporation had the option of paying the tax from either the income of 1917 or the income of 1918. This ruling is intended to apply a uniform rule in all cases regardless of whether or not the corporation set up a part of its surplus as reserves for federal taxes.

[189] Reg. 45, Art. 845.

can not be included in the computation of invested capital, except to the following extent: (1) Excessive depletion or depreciation included therein and which if charged off could be restored may be included in the computation of invested capital[190] and (2) where depreciation or depletion is computed on the value as of March 1, 1913, or as of any subsequent date, the proportion of depreciation or depletion representing the realization of appreciation of value at March 1, 1913, or such subsequent date, may if undistributed and used or employed in the business be treated as surplus and included in the computation of invested capital. For the purpose of computing invested capital, depreciation or depletion computed on the value as of March 1, 1913, or as of any subsequent date must, if such value exceeded cost, be deemed a *pro rata* realization of cost and appreciation and be apportioned accordingly. Except as above provided, value appreciation (even though evidenced by an appraisal) which has not been actually realized and, in respect of amounts accrued since March 1, 1913, reported as income for the purpose of the income tax can not be included in the computation of invested capital, and if already reflected in the surplus account it must be deducted therefrom.[191]

Patents. From the standpoint of assets a patent, or more particularly a group of patents, is closely analogous to good will. Their value is contingent upon and measured by their earning power. While patents have a definite life there is a common tendency to extend that life by improvements upon the original, and in a successful business the patent value merges more or less completely into a trade name or other form of good will. Therefore, while deductions in respect to the depreciation of patents based upon a normal life period of seventeen years are allowable in computing net income for the purpose of the income tax, such deductions are not obligatory, but are optional with each taxpayer. Where since January 1, 1909, a corporation has exercised that option to its own benefit in computing its taxable net income the amount so deducted can not now be restored in computing invested capital.[192] Thus, a corporation owning patents covering certain inventions made by its employees, the cost of securing and the salaries of such employees being paid by the corporation and charged to expense account, may not include in its invested capital any amount representing either the cost

[190] See Reg. 45, Art. 840.
[191] Reg. 45, Art. 844.
[192] Reg. 45, Art. 843.

of the patents or appreciation in their value.[193] Where, however, the cost of patents has been charged against surplus or otherwise disposed of in such a manner as not to benefit the corporation in computing its taxable net income since January 1, 1909, any amount so written off may be restored in computing invested capital, if it be shown to the satisfaction of the Commissioner that the amount so written off represented a mere book entry ascribable to a conservative policy of management or accounting and did not represent a realized shrinkage in the value of such assets. Any amount so restored may not be written off by way of deductions from taxable net income in any subsequent year or years. Where a corporation has charged to current expenses the cost of developing or protecting patents, no amount in respect thereof expended since January 1, 1909, can be restored in computing invested capital. In respect of expenditures made before January 1, 1909, a corporation now seeking to restore them must be prepared to show to the satisfaction of the Commissioner that all such items are proper capital expenditures. It can not be said that the correct computation of surplus and undivided profits necessarily requires a deduction in respect of the expiration of patents. It follows, therefore, that where a corporation in the exercise of its option has not written down the cost of patents, it is not ordinarily necessary to reduce the surplus and undivided profits in computing invested capital, whether the patents have been acquired for stock or shares or for cash or other tangible property. Due consideration will be given to the facts in any case in which this rule seems obviously unreasonable.[194]

Property Taken for Debt. Real or personal property taken by a corporation in payment or satisfaction of a debt, or property received in exchange for other property, will be an admissible asset at its fair market value upon receipt. The profit or loss, if any, resulting from the transaction will not be reflected in invested capital until the succeeding taxable year.[195]

Discount on Sale of Bonds. Discount allowed on the sale of bonds is in effect an advance on account of interest, so that the effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a

193 A. R. R. 71, T. B. 18-20-906.

194 Reg. 45, Art. 843; A. R. R. 436, T. B. 13-21-1536.

195 Reg. 45, Art. 847.

property account or otherwise carried as an asset, and is so reflected in the surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount.[196]

Bank Discount. Only the amount of discount which has actually been reported by a bank in a prior year as taxable income and credited to surplus account may be included in surplus as of the beginning of the taxable year.[197]

Current Profits. Profits earned during any year can not be included in the computation of invested capital for that year, even though during the year such profits are set up as surplus on the books or assumed to be distributed in the form of stock dividends. If a dividend is declared and paid during any year out of the profits of that year and the stockholders pay back into the corporation all or a substantial part of the amount of such dividends, the amount so paid back can not be included in the computation of invested capital unless the corporation shows by evidence satisfactory to the Commissioner that the dividends were paid in good faith and without any understanding, express or implied, that they were to be paid back.[198]

Surrender Value of Insurance Policies. Premiums paid by a corporation for insurance on the lives of its officers and employees payable to it can not be deducted as expenses in computing taxable income. Such insurance policies are considered tangible property and may be included as invested capital of the corporation at their cash surrender value at the beginning of the taxable year. The whole amount of premiums paid on such insurance can not be included in surplus, but the surplus will be considered as increased as of the beginning of each taxable year by the amount added to the cash surrender value of the policy.[199] If the policy has no cash surrender value, its loan value as of the beginning of the year is an admissible asset and may be included in invested capital.[200] The cash surrender value of a life insurance policy which constitutes surplus as at the beginning of the taxable year for invested capital purposes retains its character as surplus, even though the policy constituting the admissible asset upon the basis of which the surplus was determined is terminated and paid.[201] But where the insurance

196 Reg. 45, Art. 848.
197 Reg. 45, Art. 849.
198 Reg. 45, Art. 850.
199 Reg. 45, Art. 846; A. R. R. 229, T. B. 41-20-1239.
200 O. D. 745, T. B. 49-20-1338.
201 O. D. 179, T. B. 7-19-309.

policy is on the life of a guarantor of accounts of the corporation, the surrender value of the policy may not be included in invested capital, since the premiums thereon are deductible from gross income as business expenses.[202]

Additions to Surplus Account. A corporation's books of account will be presumed to show the facts.[203] If it claims that its capital or surplus account is understated the burden of proof will rest upon it. Additions to such accounts will be accepted to the following extent: (1) Excessive depreciation heretofore charged off on property still owned and in use, if it is now shown by satisfactory proof to have been excessive and such excess is substantial in amount, whether or not disallowed by the Commissioner as a deduction from gross income, may be restored to the surplus account. No such amount may be restored, however, unless it is shown that adequate depreciation has been deducted upon all other property of the corporation still in use, nor in any case in which such amount has been allowed as a deduction for amortization or in which the cost of the property has been recovered through being included in the price of goods or services, as for example, in the case of patterns, dies, plates, special tools, etc., or under a munition contract with a foreign government; (2) Amounts which have been expended before January 1, 1917, for the acquisition of plant, equipment, tools, patterns, furniture, fixtures or like tangible property, having a useful life extending substantially beyond the year in which the expenditure was made, and which have been charged as current expense, may (less proper deductions for depreciation or obsolescence) be added to the surplus account when such assets are still owned and in active use by the corporation during the taxable year. Special tools, patterns and similar assets will not be assigned any value if their cost has been recovered through having been included in the price of goods. If their cost has not been so recovered and they are held for only occasional use, they will not be assigned a value in excess of the fair value based upon the earnings actually arising from their current use, and in no case will such value be more than the cost less depreciation. Assets of this kind not in current use will not be valued at more than their nominal or scrap value.[204] (3) Amounts which have been expended in the past for intangible property of any kind can be restored to capital or surplus ac-

[202] O. D. 1109, T. B. 47-21-1938.
[203] O. D. 1104, T. B. 46-21-1926.
[204] Reg. 45, Art. 840; O. D. 901, T. B. 18-21-1615.

count only to the extent that the corporation specifically paid such amounts for the intangible property as such.[205] (4) Adjustments necessary to correct other errors found in the books of account may be made.[206]

Limitation of Additions to Surplus. Additions to surplus which a corporation may desire to make under the preceding paragraph fall broadly into two classes: (1) To correct returns of income for prior years in which actual errors have been made, as for example where excessive depreciation has been deducted, additions to plant and equipment or other capital charges have been charged off as an expense, inventories have been taken upon a wrong basis of valuation, etc.; (2) To reinstate in surplus deductions from income which are as a matter of good accounting to some extent optional, such as experimental expenses, patent litigation, development of good will through advertising or otherwise, etc. Adjustments falling in class (1) will be permitted for all years, whether before or after March 1, 1913, provided amended returns of income are filed for each year in which an erroneous return has been made. Due consideration will be given to the assessment of penalties in any case in which a fraudulent return has been made. Adjustments falling in class (2) can not be permitted, as in such cases it is considered that the corporation has exercised a binding option in deducting such expenses from income. An election of this sort which was made concurrently with the transaction can not now be revised, and amended returns in respect thereof can not be accepted.[207] The purpose of this rule is to prevent the inclusion in surplus or invested capital of amounts theretofore charged to expenses when an intent to evade taxation may be inferred. The doctrine of election will not be applied to transactions accomplished and consummated before the incidence of the 1909 Law, as in such cases the capitalization of items formerly charged to expense can not be impeached as an attempt to evade taxation.[208] The mere fact that a corporation did not follow

[205] A. R. M. 141, T. B. 47-21-1937; A. R. R. 32-21-1766; A. R. R. 409, T. B. 11-21-1512. It was also held under the 1917 Law that although large sums may have been spent in advertising and thereby an extensive good will may have been created, the sums so spent could not be considered as amounts paid for good will if the amounts were charged to general expense from time to time. Good will could be included only when bought and paid for specifically as such. (Letter from treasury department dated March 5, 1918.)

[206] Reg. 45, Art. 840; Reg. 41, Art. 64. See T. B. R. 6, T. B. 2-19-151.

[207] Reg. 45, Art. 841; Reg. 41, Art. 64; O. D. 901, T. B. 18-21-1615.

[208] A. R. M. 134, T. B. 27-21-1719.

the more generally approved accounting method in charging items to expense will not entitle it to capitalize items and file amended returns. Thus, a corporation which issued bonds at a discount in January, 1900, and elected then to charge such discount to profit and loss for the year of issue and the next two succeeding years, may not now revise its accounts and file amended returns for the purpose of reinstating to invested capital the unexpired portion of such discount and claiming as a deduction from income that portion applicable to each year.[209] A corporation is required to submit with its return a statement of the additions proposed, specifying the kinds and amounts of property involved, the years in which the expenditures were made, and the method followed in distinguishing between capital outlays and current expenses, and showing that adequate provision has been made for depreciation, obsolescence and depletion of such of the assets affected by the additions as are subject to recognized depreciation, obsolescence or depletion. In any case in which there is an operating deficit, amounts restored must first be set off against the deficit and only the excess can be actually included in the computation of invested capital.[210]

Property Paid in and Subsequently Written Off. Where tangible or intangible property has been paid in to a corporation for stock or shares or as paid-in surplus, and has subsequently been in whole or in part written off the books, the amount so written off may upon evidence satisfactory to the Commissioner be restored to the capital or surplus account subject to the following limitations: (1) The amount restored must be reduced by a proper deduction for any depreciation, obsolescence or depletion; and (2) the aggregate amount included in computing invested capital on account of such property must not exceed the amount which might have been included if such property had not been written off.[211]

Borrowed Capital. The term "borrowed capital" means money and other property borrowed, whether represented by bonds, notes, open accounts, or otherwise.[212] Invested capital

[209] A. R. R. 394, T. B. 8-21-1472.

[210] Reg. 45, Art. 841.

[211] Reg. 45, Art. 842.

[212] Revenue Acts of 1918 and 1921, § 325 (a). Under the 1917 Law it was held that the term "money or other property borrowed" included not only cash or other borrowed property which could be identified as such, but current liabilities and temporary indebtedness of all kinds, and any permanent indebtedness upon which the taxpayer was entitled to an interest deduction in computing net income. A corporation which was allowed to

does not include borrowed capital.[213] Where the amount of borrowed capital is abnormal, however, the taxpayer may apply for assessment by reference to representative corporations.[214] Stockholders have no vested right in the surplus of a corporation. A corporation can not, without consideration, issue notes to its stockholders for the amount of its surplus, except by declaration of dividends *pro rata* according to stockholdings. Treasury demand notes (never delivered) drawn by order of the president of a corporation payable to its stockholders, but not in proportion to stockholdings, do not constitute a liability of the corporation, even though such notes are charged against surplus on the company's books.[215] Items such as deposits or amounts due to other banks shown in the balance sheet of a bank, unexpired subscriptions shown in the balance sheet of a publishing concern, etc., are deemed liabilities and can not be included in computing invested capital.[216] Any interest in a corporation represented by bonds, debentures or other securities, by whatever name called, including so-called preferred stock, if with respect to the payment of either interest or principal it ranks with or prior to the interest of the general creditors, is borrowed capital and can not be included in computing invested capital. Any such preferred stock, may, however, be so included if it is deferred with respect to the payment of both interest and principal to the interest of the general creditors.[217] Preferred stock if in the records of the corporation it is declared to be part of its capital stock though convertible into first-mortgage bonds of even date therewith, is inferior, on a distribution of assets to pay debts, to the rights of general creditors, and is to be treated

deduct only a part of the interest paid on its indebtedness might include in invested capital such proportion of its permanent indebtedness as the amount of interest upon such indebtedness which the corporation was not allowed to deduct bore to the total amount of interest paid upon such indebtedness during the taxable year. (Reg. 41, Art. 44.)

213 Revenue Acts of 1918 and 1921, § 326 (b).

214 See p. 1116.

215 A. R. R. 473, T. B. 17-21-1602.

216 Reg. 45, Art. 814.

217 Reg. 45, Art. 812. Where the principal stockholder of a corporation loans money to the corporation and, in order to protect the credit of the corporation, an agreement is signed to the effect that the lender shall be deferred to all other creditors and shall receive one per cent. additional interest in consideration thereof, which interest is not deducted by the corporation as expense, the amount of the loan cannot be included in invested capital as preferred stock. (Telegram from Treasury Department dated April 4, 1919; W. T. S. 1919, ¶ 1021.)

as invested capital so long as it is not converted.[218] The question is not what the parties call an instrument but what the facts and circumstances require it to be called. The courts are not influenced by mere names but look beyond names and give to the subject dealt with the character and status which its properties denote it possesses.[219] The term "debenture" is well known in England to describe any instrument issued by a corporation which creates or acknowledges a debt. As stated by Lindley, debenture stock is of the same nature as ordinary debentures, except that instead of each bond securing a definite amount, the whole sum secured is treated as a single stock, the bonds are issued declaring the holder to be entitled to a definite sum, part of this stock. This sum is not necessarily a round sum, but may be for any number of pounds, it may include fractions of a pound unless limitation is made in that respect. A debenture stock may be repayable at a fixed date, or may be irredeemable, according to the deed creating it, and may be secured in any manner in which a debenture may be secured.[220] Irredeemable notes or bonds are not so well known in this country. There are instances, however, of such perpetual debts and it has been held that the character of such obligations is not affected by the fact that they are not redeemable at a fixed time.[221] Certificates stating that a corporation is indebted in a specified amount to the holders thereof payable at the expiration of corporate existence, the payment of the principal being subordinated to other indebtedness, may still be regarded as a debt and consequently as borrowed capital. Such certificates do not constitute preferred stock. The term "stock" does not mean a debt but refers to an interest in a corporate enterprise.[222]

218 S. 1200, T. B. 27-19-609.

219 Spencer v. Smith, 201 Fed. 647; Heller v. National Marine Bank, 89 Md. 601, 43 Atl. 800.

220 Lindley's Company Law, 195.

221 Philadelphia & Reading R. Co. v. Stichter, 11 Weekly Notes of Cases, Pennsylvania, 325.

222 It should be noted that the instruments under consideration in this ruling afforded some security to the holders thereof by a provision preventing the corporation from mortgaging its property or franchises without the written consent of at least two-thirds of the holders. There were no indications that the parties intended the holders to be stockholders, the certificates having been issued under a clause in the charter granting power to borrow money and not to issue stock. The certificates provided specifically for the payment of interest at a specified rate per annum. There was no qualification in the charter or by-laws of the company limiting this obligation and no reason appeared why the holders of such cer-

Whether or not amounts received by a corporation upon the sale of so-called debenture stock constitute invested capital or borrowed capital depends upon the rights and powers enjoyed by the holders of such stock and the obligations with respect thereto undertaken by the corporation; where so-called debenture stock is issued by a corporation for cash or property under a power granted by the charter to borrow money, and the certificates of such stock contain an agreement on the part of the corporation to repay the face amount thereof upon dissolution, and to pay interest thereon from time to time, at a certain rate per cent. per annum; and where it appears that the claim of such debenture stockholders will, upon dissolution of the corporation, be subordinate to the claims of general creditors but superior to the claims of the ordinary stockholders; and where it further appears that the holders of such certificates exercise no voice in the control or management of the corporation, the amounts received for the sale of such stock constitute borrowed capital, and the interest paid thereon, from time to time, by the corporation is properly deductible as a business expense.[223] Where upon the organization of a corporation bonds were issued for the tangible property received and interest was paid to the owners of such bonds up to the year 1917 (paid and deducted by the corporation to the year 1917) it has been held under the Revenue Act of 1917 that the amount of such bonds is borrowed capital and can not be included in invested capital even though the minutes of the organization meeting of the corporation contained a resolution providing that the bonds should be "subject to all rights of creditors of said corporation now existing and at all times existing during the terms of said bonds" and even though in 1918 the bondholders turned in their bonds in exchange for preferred stock. It was held that the fact that the corporation did not deduct interest on the bonds in filing its 1917 returns was not sufficient to change or fix the status for pur-

tificates could not sue for the interest if default in payment was made. These considerations were foreign to the idea of preferred stock since a preferred stockholder is not a creditor of the corporation (Warren v. King, 108 U. S. 389, 2 Sup. Ct. 789) and cannot sue for dividends unless they are declared. Moreover, there was no indication in the charter or by-laws of an intent that the holders of the certificates should share in the corporate assets over and above the first amount of their interest.

[223] A. R. R. 237, T. B. 33-20-1142. Upon the question of including debenture stock in invested capital see also Doershuck v. U. S., U. S. Dist. Ct. E. D. N. Y.; T. D. 3170, T. B. 24-21-1681.

poses of invested capital nor was the subordination of the liens of the bonds to the claims of general creditors.[224]

Amounts Paid into or Left in Business. Whether a given amount paid into or left in the business of a corporation constitutes borrowed capital or paid-in surplus is largely a question of fact. Thus, indebtedness to stockholders actually canceled and left in the business would ordinarily constitute paid-in surplus, while amounts left in the business representing salaries of officers in excess of their actual withdrawals or deposit accounts in favor of partners in a partnership succeeded by the corporation, will be considered paid-in surplus or borrowed capital according to the facts of the particular case. Where a valid obligation on the part of a corporation to pay salaries to officers exists, and the officers waive their rights to a part of such salaries, the amount waived constituted paid-in surplus.[225] The general principle is that if interest is paid or is to be paid on any such amount, or if the stockholdes' or officers' right to repayment of such amount ranks with or before that of the general creditors, the amount so left with the corporation must be considered as borrowed capital.[226] Special accounts of stockholders created because of amounts left in the business by certain of the stockholders only and represented by interest-bearing notes in favor of such stockholders, cannot be considered invested capital, even though such notes carry a condition that demand for payment will not be made until all general creditors are satisfied.[227] In 1915 the principal stockholders paid into a company a sum of money, no stock being issued therefor, no interest charged, and no action was taken by the corporation to indicate the nature of the payment except that it was entered as a contribution to capital and was never treated as an account payable. The sum was repaid in 1917, there being no evidence as to the nature of the payment nor how it was treated by the corporation. It was held that the payment was in the nature of a voluntary assessment; that the repayment must be deemed to be out of undivided profits or earned surplus so far as possible; that such repayment could not be treated as a return of capital unless the undivided profits and earned surplus accumulated since March 1, 1913, were first distributed as dividends; that the corporation should be permitted to include the amount in its

[224] A. R. R. 116, T. B. 21-20-962.
[225] O. D. 1034, T. B. 37-21-1821.
[226] Reg. 45, Art. 813.
[227] A. R. R. 356, T. B. 52-20-1366; A. R. R. 102, T. B. 21-20-963.

invested capital for 1917 as paid-in surplus, proper adjustment being made for any distributions of dividends in excess of available net earnings.[228]

In a case arising under the 1917 Law, an amount was paid in to a corporation regularly by its stockholders under a resolution making an assessment upon such stockholders. This amount was entered on the corporation's books as a capital reserve fund and in 1917 was carried as "advances by stockholders." No stock was issued for the amount and no notes were given by the corporation acknowledging its indebtedness to the stockholders therefor. Interest was paid upon the advance and was deducted by the corporation regularly each year in computing net income. The treasury department held this advance by the stockholders not to constitute borrowed capital and permitted its inclusion in invested capital on the theory that the stockholders would not be entitled to repayment before the general creditors had been satisfied. The interest paid by the corporation was regarded as in the nature of a dividend upon preferred stock.[229]

DIVIDENDS CREDITED TO STOCKHOLDERS. Where a corporation by the consent of all the stockholders, declares dividends, but through lack of cash with which to make actual payment credits the amount of the dividends to the accounts of the shareholders, such dividends being treated as liabilities of the corporation and no interest being paid or accrued thereon, it has been held that the effect on the corporation's surplus and the rights of the stockholders are the same as if the dividend had been formally declared and paid. The corporation, while having the use of the amounts so credited, is at all times liable for them to the stockholders and must treat such amounts as borrowed capital.[230]

INFORMAL DIVIDENDS; CREDIT BALANCES TO STOCKHOLDERS' ACCOUNTS. Where a corporation notes and credits to its stockholders their *proportionate* shares of each year's earnings to which they would be entitled under a dividend declaration, and such stockholders return such credited earnings and pay income tax thereon, but no interest is paid upon the amounts standing to the credit of the stockholders and no formal dividend declaration is made by the board of directors, the amounts so credited may be regarded as a part of earned surplus, provided that under the state law the stockholders do not rank

[228] T. B. M. 82, T. B. 23-19-552.
[229] A. R. M. 44, T. B. 18-20-905. See also A. R. R. 78, T. B. 18-20-904.
[230] O. D. 1006, T. B. 34-21-1786. See p. 1066.

with general creditors in respect of such credits.[231] But in a case arising under the 1917 Law [232] very similar in its facts except that the balances standing to the credit of the stockholders were not in proportion to their stockholdings a different conclusion was reached. The corporation involved had three stockholders. During the lifetime of these stockholders no distribution of profits was made and the earnings were allowed to accumulate from year to year. At the death of one stockholder, in 1907, the board of directors passed a resolution ordering the reserve fund to be prorated and credited to the deposit accounts of the three principal stockholders, which was done. None of these profits was withdrawn; the business proceeded as before and the profits were allowed again to accumulate until 1909, when a second stockholder died, and the same procedure was taken as in 1907. From the inception of the business no dividend was ever declared nor were any of the profits withdrawn from the business or segregated from surplus except as above stated; but against the accounts credited comparatively small charges were made from time to time to cover living expenses of two of the stockholders. Substantially all of the profits thus credited, by verbal agreement were left in the corporation funds for the conduct of its business; on the amounts so credited no interest was ever paid by the corporation nor were notes issued therefor, for the reason that they were never considered as obligations of the corporation; but, on the contrary, as funds left in the business to be used as capital; and banks and other large creditors of the corporation were cognizant of this verbal agreement, and by reason of it extended credit to the corporation on these funds considered as capital. It was admitted that the credits were not "surplus" in the sense that all the stockholders had a right to share in them ratably. The committee on appeals and review ruled that the credits ranked, in law, with the claims of other general creditors; even though by the good faith and honor of the three stockholders, they would be voluntarily deferred until the claims of the other general creditors had been liquidated in full and that the corporation was not being penalized merely because of its failure to have made a "book entry" converting these credits into capital stock because the credits, being a direct and fixed obligation of the corporation, had not the same

231 A. R. M. 71, T. B. 29-20-1081.

232 The 1917, 1918 and 1921 Laws are not distinguishable in their provisions governing the point.

status among the corporation's liabilities as would have been the case had they, by formal action of the board, been converted into capital stock and certificates issued therefor, or had the interested stockholders waived all proprietary rights to them and thus actually contributed them to surplus.[233]

CONVERSION OF BONDS INTO STOCK. Where bonds are exchanged for stock in the same corporation under the terms of a convertible trust deed, it will be presumed, for the purpose of computing invested capital, that the value of the bonds is equivalent to the value of the stock. The addition to invested capital would accordingly be the amount for which the bonds were originally sold.[234]

Computing Invested Capital. In computing invested capital the first step is to add together the paid-in capital and paid-in or earned surplus and undivided profits (under whatever name the same may be called) as shown by the books at the beginning of the taxable year. The total thus obtained is to be adjusted for any asset or item which it covers that is not carried on the books at the valuation prescribed by law.[235] After the various adjustments are made the adjusted total of the capital and surplus account will represent the invested capital at the beginning of the taxable year. If there has been any change made during the taxable year in the amount of invested capital, the reduction or increase must be noted in order to average the invested capital for the year. Whenever any corrections are made in respect of the capital stock or surplus, corresponding corrections must be made in the respective asset items in the balance sheet of the taxpayer accompanying the return.[236] But it is not necessary that the books also be changed, provided some permanent record of the adjustments is kept.[237]

Admissible Assets. The term "admissible assets" means all assets other than inadmissible assets. Organization expenses and deferred charges against future income are admissible assets. Admissible assets must be valued in accordance with the provisions of the law regarding invested capital.[238] Thus, for example, intangible property paid in for stock or shares is an admissible asset, but it cannot be valued at an amount in excess of that at which it may be included in computing invested

233 A. R. R. 102, T. B. 21-20-963.

234 O. D. 306, T. B. 24-19-577.

235 This was the rule under the 1917 Law. See Reg. 41, Art. 53.

236 Reg. 41, Art. 53.

237 Letter from treasury department dated March 19, 1918.

238 Revenue Acts of 1918 and 1921, § 325.

capital under the provision of law limiting such amount to 25% of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, or at the beginning of the taxable year accordingly as such property was paid in prior to or on or after March 3, 1917.[239]

SCHOOL DISTRICT WARRANTS. Warrants drawn by a school district on the superintendent of schools for a county in favor of the teachers of public schools of a district and cashed by a bank, but returned by the superintendent with a notation of "no funds" and carried by the bank without any remuneration in the form of interest or discount are admissible assets, since obligations to be inadmissible must be potentially interest-bearing or dividend-producing securities.[240]

INSURANCE POLICIES. Insurance policies on the lives of officers are admissible assets, as indicated elsewhere in this chapter.[241]

Inadmissible Assets. The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States) the dividends or interest from which are not required to be included in computing net income.[242] Where, however, the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation upon the deduction of interest,[243] the corresponding part of such assets is not deemed to be inadmissible.[244] A corporation cannot by including the income from inadmissible assets as taxable income create the right to have such assets considered admissible assets.[245] Inadmissible assets will for the

[239] Reg. 45, Art. 818. Revenue Acts of 1918 and 1921, § 326 (a) 4, 5. Good will so far as it is built up and developed by advertising not charged to expense may be included in invested capital. A corporation may in the future exercise an option and, if it so desires, treat advertising as a capital item, not deducting it as an expense, in which case it may become entitled to include a *pro tanto* amount of good will in its invested capital and make an addition to surplus accordingly.

[240] O. D. 1096, T. B. 45-21-1915.

[241] See p. 1063.

[242] Under the 1917 Law inadmissible assets were such stock, bonds or other assets the income of which was not subject to the excess-profits tax. (Reg. 41, Art. 44.)

[243] See Revenue Acts of 1918 and 1921, § 234 (a) 2.

[244] Revenue Acts of 1918 and 1921, § 325.

[245] Reg. 45, Art. 815.

purpose of discussion in the following paragraphs be divided into three classes, (1) stocks of domestic corporations; (2) stocks of foreign corporations, and (3) bonds and other obligations.

Stock in Federal Reserve Bank. Federal Reserve Bank stock, held by a member bank, is an inadmissible asset in determining invested capital.[246]

Stock of Domestic Corporations. The statute apparently intends that stocks of domestic corporations are *ipso facto* inadmissible assets in computing the invested capital of the stockholder. The law provides that the term "inadmissible assets" means "stock * * * the dividends * * * from which is [are] not included in computing net income."[247] Hence it follows that it is immaterial whether the corporation whose stock is held actually pays dividends thereon or not, or whether its operations are carried on within or without the jurisdiction of the United States. Although many corporations find it necessary for business reasons to hold stock in other corporations which do not pay dividends and such investment is in fact a necessary and proper investment, as for instance where several corporations may own the stock of storage, warehouse or terminal companies for their joint benefit (such jointly held corporations not being intended to pay dividends) the stock is nevertheless inadmissible under a literal interpretation of the law. To hold that stock of a domestic corporation is admissible if the corporation paid no dividends, during the taxable year, but inadmissible if the corporation paid dividends and the same were not included in the net income of the stockholder, would be to establish an impracticable rule, and one plainly not intended by the language of the law. Hence it has been ruled that the failure to pay or to receive dividends does not change the status of stock as an inadmissible asset.[248] Apparently the only way that stock of a domestic corporation can become an admissible asset is by selling the stock, in which case the profit is included in net income and all or a portion of the value of the stock becomes an admissible asset, as is more fully stated in a subsequent paragraph.

Stock of Domestic Corporations Deriving Substantial Income from Possessions of the United States. The Revenue Act of 1921 provides for the taxation of domestic corpora-

[246] Letter from treasury department dated March 13, 1919; W. T. S. 1921, ¶ 744; O. D. 81, T. B. 1-19-118.

[247] Revenue Acts of 1918 and 1921, § 325 (a).

[248] Reg. 45, Art. 815.

tions only with respect to income from sources within the United States, if such domestic corporations derive 80% of their gross income for a three-year period preceding the close of the taxable year from sources within a possession of the United States (excluding the Virgin Islands), and 50% of their gross income for such period from the active conduct of a trade or business within a possession of the United States.[249] Dividends on the stock of such corporations are not deductible from the gross income of corporations, and such stock is, therefore, an admissible asset.[250]

STOCK OF FOREIGN CORPORATIONS. If a foreign corporation paid an income tax to the United States on any part of its income, its dividends were not taxed under the 1918 Law when received by a domestic corporation;[251] and it followed that the stock of such foreign corporation was an inadmissible asset.[252] On the other hand, if such foreign corporation paid no income tax to the United States its stock was an admissible asset.[253] This rule is changed by the Revenue Act of 1921. Dividends from a foreign corporation are free from tax under the present law, when received by a corporation only if it is shown that more than 50% of the gross income of such foreign corporation, for the three-year period ending with the close of the taxable year preceding the declaration of dividends, was derived from sources within the United States.[254] The stock of foreign corporations with respect to which this can be shown will be inadmissible assets under the present law; the stock of other foreign corporations will be admissible assets.[255]

BONDS OR OTHER OBLIGATIONS. The bonds or other obligations which are inadmissible assets are only those "the interest

249 Revenue Act of 1921, § 262.

250 Revenue Act of 1921, §§ 234 (a) 6, 325 (a).

251 Letter from treasury department dated June 9, 1919; I. T. S. 1919, ¶ 3427. See Chapter 19.

252 O. D. 305, T. B. 24-19-576.

253 The rule was different under the 1917 Law. See Reg. 41, Arts. 27 and 46. But it seems that the rule stated in the text is applicable to assessments under that law as well as the present law. Formerly in the case of a domestic corporation or partnership and of citizens or residents holding stock in a foreign corporation part of whose net income was subject to tax, there might be included in invested capital such proportion of the value of the stock as the net income of such foreign corporation from sources outside the United States was of its entire net income. (Reg. 41, Art. 46.)

254 Revenue Act of 1921, § 234 (a) 6.

255 Revenue Act of 1921, § 325 (a).

from which is not included in computing net income."[256] Bonds and securities of industrial or railroad corporations—domestic or foreign—are admissible, even though the bond may have a so-called "tax-free covenant." Bonds issued by exempt corporations are admissible assets. Bonds and obligations of the United States are admissible, even if the interest is exempt. Such bonds, however, are only bonds of the federal government and not of its possessions. Bonds and obligations which are inadmissible assets are those issued by a state or territory (or a political subdivision of either, i. e., county, city, township, etc.), the District of Columbia and the possessions of the United States, and also securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916.[257] Bonds of the War Finance Corporation are admissible if the income therefrom is subject to the tax, but that part of the principal amount of such bonds with respect to which interest may be exempt from excess-profits tax is inadmissible. Thus, bonds of the War Finance Corporation the principal of which does not exceed $5,000 are inadmissible assets, and bonds of the War Finance Corporation the principal of which exceeds $5,000 are admissible assets.[258] Since the income derived from Porto Rico and Hawaii bonds is not subject to tax, the bonds are inadmissible assets and can not therefore be included in invested capital.[259] Four per cent. bonds of the government of the Philippine Islands are also inadmissible assets.[260] The conversion of certificates of indebtedness purchased by a corporation in 1918 into Victory Liberty Loan notes of the same value does not affect invested capital.[261] In computing the amount of admissible assets, the total cost of bonds subscribed for, whether fully paid or not, may be included in admissible assets.[262] Federal land bank bonds[263] and school warrants issued by a county of a state[264] have also been held to be inadmissible assets. Where a corporation engaged in paving work for municipalities in a state, the statutes of which provide that municipal improvements shall be paid for by assessments issued to the contractor,

256 Revenue Acts of 1918 and 1921, § 325 (a).

257 Reg. 45, Arts. 815-816.

258 Official announcement by the bureau of internal revenue dated April 5, 1919; O. 781, T. B. 1-19-116.

259 O. D. 86, T. B. 1-19-125; O. D. 1044, T. B. 38-21-1836.

260 O. D. 1057, T. B. 40-21-1857.

261 O. D. 93, T. B. 1-19-132.

262 O. D. 28, T. B. 1-19-40.

263 O. D. 1069, T. B. 42-21-1875.

264 O. D. 929, T. B. 21-21-1656.

such assessments bearing interest from the date of acceptance of the work by the city engineer and the contractor receiving interest from this source from the date of acceptance to the date of delivery of the certificates of indebtedness (which were assigned to a bank under an agreement for the advance of operating expenses, a discount being paid the bank in addition to accrued interest on the funds advanced for the prosecution of the work) it has been held that the interest received by the contractor is exempt and therefore the principal upon which such interest accrued is an inadmissible asset.[265]

Inadmissible Assets May Become Admissible. Under two conditions assets which are otherwise inadmissible become in whole or in part admissible: (1) Where the inadmissible asset has been sold during the year and the profit thereon is included in net income, and (2) where inadmissible assets have been purchased or carried during the year with borrowed money and the interest paid on such borrowed money is not allowed to be deducted in ascertaining the net income.[266] Where inadmissible assets have been sold or otherwise disposed of, the total income from such assets including the profit on the sale and the interest or dividends received during the year is first ascertained. Secondly, the percentage of the entire net income attributable to the profit on the sale of the asset is ascertained and the same percentage of the intangible asset becomes invested capital for the length of time such asset was owned by the corporation.[267] In the second class of cases it seems that the interest received from the inadmissible asset should be compared with the interest paid upon the money borrowed to purchase or carry such asset. Thus, if the interest received is $100 and the interest paid on the borrowed money is $75, three-fourths of the inadmissible asset becomes admissible (since three-fourths of the interest is in effect included in taxable income). This applies separately to each issue or class of inadmissible securities held by a corporation. For example, it may hold A company stock costing $100,000 and B com-

265 O. D. 999, T. B. 34-21-1778.

266 See Revenue Acts of 1918 and 1921, § 234 (a) 2, also Chapter 23.

267 Under the 1917 Law it was held that wherever income consisted partly of gains or profits subject to the excess-profits tax arising from trading in stocks, bonds, etc., the dividends or interest on which were not subject to such tax, and partly from such dividends or interest, there could be included in the invested capital an amount which bore the same ratio to the total amount invested in such stock or bonds as the amount of such trading profits bore to the total amount of trading profits and dividends or interest. (Reg. 41, Art. 45.)

pany stock costing $200,000. During the year it receives $8,000 in dividends from A company and $5,000 from B company, and on September 30 sells part of its B company stock at a profit of $3,000. For the period from January 1 to September 30, $75,000 of its holdings of B company stock becomes admissible. After September 30 its remaining holdings of B company stock are inadmissible, but the proceeds of the sale are admissible unless invested in inadmissibles.[268]

Reduction of Invested Capital by Inadmissible Assets. From invested capital must be deducted a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the year.[269] In other words, after the invested capital has been determined without reference to inadmissible assets but eliminating borrowed capital, the invested capital so determined is reduced by taking a percentage equal to the percentage of inadmissible assets to all the assets held during the taxable year.[270] For the purpose of ascertaining the deductible percentage the amount of inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount held at the end of the year. The total amount of admissible and inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount at the end of the year. If at any time a substantial change has taken place either in the amount of inadmissible assets or in the total amount of admissible and inadmissible assets, the effect of such change should be averaged exactly from the date on which it occurred. In any case where the Commissioner finds that either amount determined as above provided does not substantially reflect the average situation

268 Reg. 45, Art. 817.

269 Revenue Acts of 1918 and 1921, § 326 (b). When invested capital was determined under the 1917 Law irrespective of admissibles and inadmissibles the adjusted total of capital and surplus represented invested capital at the beginning of the taxable year, except that where admissible assets were less than the amount of such adjusted total, a further reduction was necessary to an amount equal to the sum of the admissible assets. If there had been any change during the year in the amount of invested capital, the monthly average was taken (Reg. 41, Art. 53).

270 Under the 1917 Law it was ruled that only so much of the admissible assets as exceeded the borrowed money need be deducted from invested capital. See letter from Treasury Department dated April 2, 1918; W. T. S. 1918, ¶ 923 and letter dated May 17, 1918, Id. ¶ 955.

throughout the year, and that the amount of each kind of assets held on a given day of each month throughout the year or at more frequent regular intervals can be determined, the amount of inadmissible assets and the amount of both kinds of assets held during the year will be determined by averaging the amounts held at such several times. In making these computations the valuation at which each asset is carried must be adjusted in accordance with the provisions of the statute and of the regulations relating to the valuation of assets for the purpose of computing invested capital including in such adjustment the amount of reserves for depreciation, depletion, amortization and other reserves which represent the valuation of assets. It is immaterial whether any asset was acquired out of invested capital, or out of profits earned during the year, or borrowed capital.[271]

Adjustments Which Increase Book Values of Assets. The adjustments which may increase the book value of the assets representing capital and surplus at the beginning of the year (and thus increase the surplus for purposes of invested capital) are stated in the preceding paragraphs.[272] Briefly summarized they are (a) the value of tangible property paid in in excess of the par value of the stock issued therefor; (b) additions to the capital account due to restoring to the capital account the value of assets the cost of which has been charged to expense; (c) reinstating the value of assets which has been unduly reduced on the books of the company, and (d) the inclusion of reserves or such parts of reserves as are in fact surplus or undivided profits. In support of the claim for additional invested capital with respect to any of these items it is necessary to file statements showing the information indicated in the respective paragraphs above.

Adjustments Which Reduce the Book Value of Assets. Assets may be carried on the books at a valuation greater than that which the law expressly allows or contemplates. In such cases the value of such assets must be reduced to within the

[271] Reg. 45, Art. 852. As to affiliated corporations see p. 1132. Under the 1917 Law, if admissible assets were in excess of adjusted capital and surplus, no further deduction was required because of inadmissible assets; in other words, only the excess of inadmissible assets over total indebtedness was required to be deducted from adjusted capital and surplus (A. R. R. 111, T. B. 21-20-964). This ruling is inapplicable under the present statute, which provides for the deduction of a *percentage* of inadmissibles.

[272] See p. 1064.

limit allowed by law and the capital, surplus or undivided profits of a company reduced accordingly. Cases in which adjustment must be made to reduce the book value are stated in the following paragraphs.

As to Value of Intangible Assets. As stated above in the paragraphs relating to intangible property paid in[273] the value thereof must be reduced to the lowest of three values: (a) the actual cash value at the time of acquisition; (b) the par value of the stock issued therefor, or (c) 25% of the par value of the stock outstanding on March 3, 1917, or at the beginning of the taxable year as the case may be. The difference between such minimum value and the value at which the assets are carried on the books of the company is the amount to be deducted in this adjustment.

As to Treasury Stock. When any treasury stock is returned to the corporation as a gift or for a consideration substantially less than its par value, the stock so returned may not be treated as a part of the stock issued or exchanged for property. The proceeds derived in cash or its equivalent from the resale of such treasury stock should however be included in the invested capital, if retained and employed in the business.[274] The difference between the par value of the treasury stock so returned as a gift and the amount of cash or its equivalent which was derived from the resale of such stock is required to be deducted from invested capital.[275] Where a corporation either directly or indirectly, as for example through a trustee, has prior to the taxable year bought its own stock, either for the purpose of retirement or of holding it in the treasury or for other purposes, the entire cost of such stock must be deducted from the aggregate invested capital as of the beginning of the taxable year, if such deduction has not already been made. Where such stock is purchased during the taxable year a deduction from the invested capital as of the beginning of the taxable year and effective from the date

[273] See p. 1049.

[274] Reg. 45, Art. 861; Reg. 41, Art. 54.

[275] See Form 1120 for 1918, Schedule G3. There may be cases, however, where the subsequent return of stock to the corporation is in fact equivalent to an additional contribution of capital equal to the amount received by the corporation on the resale of such stock. Where stock has been issued for property and a part of the stock is returned to the treasury of the corporation, the presumption is that the property was consciously overvalued, but this presumption cannot stand if contrary to fact.

of such purchase is required only to the extent that such stock has not been purchased out of the undivided profits of the taxable year. The full amount derived in cash or its equivalent from the resale of such stock may be included in invested capital from the date of such resale, unless such stock had been purchased out of earnings of the taxable year.[276]

As to Value of Assets Acquired in Reorganization. In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917,[277] certain reductions may be necessary in the book values of the new owner, if such book values reflect the value of the property at the time it was acquired by such new owner. Such reduction is necessary only in cases where 50% or more of the interest or control in such trade or business or property remains in the same persons, or any of them. In such cases no asset so acquired will, for the purpose of determining invested capital, be allowed a greater value than would have been allowed in computing the invested capital of the previous owner if such asset had not been so transferred to the new owner. In other words, if the previous owner was a corporation and 50% or more of the interest or control of the new corporation remains in the hands of any of those who controlled the old corporation, the intent of the statute seems to be that the invested capital of the new corporation cannot be increased as to such property beyond the amount which would have been allowed to the old corporation had it retained the assets. This is true whether or not the assets were paid for by the new corporation in stock or in cash.[278] If the previous owner was not a corporation, then the value of any asset so transferred must be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost may be made

[276] Reg. 45, Art. 862.

[277] This restriction only applies in the case of a reorganization or change of ownership after March 3, 1917 (O. D. 1097, T. B. 45-21-1916). It applies whether property transferred is tangible or intangible (A. R. R. 383, T. B. 8-21-1470).

[278] Under the 1917 Law this restriction on the value of assets acquired on a reorganization after March 3, 1917, applied only to cases where the asset was not paid for specifically as such in cash or tangible property, (Revenue Act of 1917, § 208; Reg. 41, Art. 50) but under the present law it applies also to cases where payment may have been made in cash or by tangible property. (Revenue Acts of 1918 and 1921, § 331.)

for any charge or expenditure deducted as expense, or otherwise, on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.[279] In all such cases the reduction to be made is the difference between (a) the book value of such assets, and (b) in case the previous owner was a corporation, the value at which the asset would have been considered invested capital to it, or (c) in case the previous owner was an individual the cost of such asset to such owner, as indicated above.

It will be noted that the Revenue Act of 1918 in its provision regarding reorganizations extends the corresponding provision of the Revenue Act of 1917 to include a "change of ownership of property after March 3, 1917." [280]

A new corporation which raises a certain sum from the sale of its capital stock as a condition precedent to taking over from the creditors of a defunct corporation the old corporation's assets and assuming its liabilities will not be allowed as invested capital the amount which the old corporation could have claimed. It is limited to the amount received from the sale of its capital stock. The value of the property received on condition of the assumption of the unpaid liabilities of the old corporation is borrowed capital.[281] In this case the old corporation had gone into the hands of a receiver and its property sold to its creditors who were not stockholders. The transaction was closed and completed so far as the old corporation and its stockholders were concerned. The fact that the stockholders of the old and new corporations were identical does not affect the question.

DEFINITION. Where under the laws of a state a charter granted to a corporation is limited to a period of years, the renewal of such charter merely prolongs the existence of the original corporation and does not of itself constitute a reorganization within the meaning of the excess-profits tax laws.[282]

The expression "remains in control" has been construed to cover a case in which the assets of a partnership were taken over by a corporation, the former partners receiving approximately 49% of the capital stock of the new corporation, but

[279] Revenue Acts of 1918 and 1921, § 331; A. R. R. 393, T. B. 8-21-1470; A. R. R. 618, T. B. 39-21-1849; O. D. 789, T. B. 5-21-1424. Cost may include expenditures for good will not charged to expense, even though written off the books prior to the change of ownership.

[280] A. R. R. 285, T. B. 42-20-1252.

[281] T. B. M. 49, T. B. 11-19-389.

[282] O. D. 930, T. B. 21-21-1657.

becoming the principal officers thereof. The decision was founded upon the consideration that upon the reorganization the partners received all the stock of the new corporation, 51% of which they then disposed of to the public.[283] It has been held that where the owner of a business turned the business over to a corporation practically all the stock of which was issued to his children and close connections, an interest or control of 50% or more did not remain in the same persons; the offer to sell the assets of the business was construed as an enforceable agreement based upon a valid consideration for the benefit of third persons.[284]

REORGANIZATIONS ENTITLING CORPORATIONS TO REVALUATION. The provision referred to in the preceding paragraph provides negatively that in the case of a reorganization, consolidation or change of ownership of a trade or business or change of ownership of property after March 3, 1917, if an interest or control in such trade or business or property of 50% or more

[283] A. R. R. 409, T. B. 11-21-1512. The validity of this ruling seems extremely doubtful. It is founded upon the technical argument that the "proceeds from the sale of any or all of the stock passed to the partnership. Out of these proceeds the partners paid to the corporation such amount or amounts as the partners had agreed to pay in part consideration for the stock received by them. In other words, the transaction was between the corporation and the partners and the latter named the proportion in which they desired the stock distributed to them and to their nominees. Hence, the partners did remain in control. They exercised this control in naming their nominees. It is immaterial that this stock control was not continuing—that it immediately passed by a small fraction into other hands". It would seem material under the statute whether the control is continuing. The word "remains" might well be given a broader construction than that above indicated in which it is limited to conditions *immediately* before and after the change of ownership. Moreover, to say that the partners exercised their control by naming nominees is utterly to defeat the statute. In all cases of a reorganization or change of ownership the old stockholders or owners do this, and if it is to preclude an increase of invested capital, the statutory provision might as well include *all* reorganizations and changes of ownership, rather than those only in which a 50% interest or control remains in the same persons.

[284] A. R. R. 645, T. B. 42-21-1890. This was an absolutely *bona fide* transaction, and there was no doubt that the issuance of the stock to the children was unconditional. The father was actuated by a desire to provide for his children during life and then retire from active business. On the point that where two parties enter into an agreement under which third persons are to receive a benefit, the contract is enforceable, see Cobb v. Heron, 180 Ill. 49, 54 N. E. 189, aff'd 78 Ill. App. 654; Deen v. Walker, 107 Ill. 540; Bay v. Williams, 112 Ill. 91; Hartman v. Pistorious, 248 Ill. 568, 94 N. E. 131; Searls v. Flora, 225 Ill. 167, 80 N. E. 98; Harms v. McCormick, 132 Ill. 104, 22 N. E. 511.

remains in the same persons, or any of them, then no asset transferred or received shall be allowed a greater value in determining invested capital than would have been allowed to the previous owner. Two inferences are to be fairly drawn from this provision: (1) assets in the case of reorganization *prior to* March 3, 1917, should be valued as of the date of transfer to the new corporation for the purpose of determining the invested capital of such corporation for the taxable year;[285] (2) assets in the case of a reorganization after March 3, 1917, should be valued as of the date of the transfer to the new corporation for the purpose of determining the invested capital of such corporation for the taxable year, *if an interest or control in the trade, business or property transferred upon the reorganization does not remain to the extent of 50% or more in the same persons.* In cases arising upon this side of the question a revaluation of assets has been permitted for purposes of determining invested capital. It has been expressly ruled that in a case falling under (1) above a revaluation of assets is to be permitted for purposes of invested capital where there was a change of corporate entity prior to March 3, 1917, even though there was no change of officers, or directors, or proportions of stockholders. Inasmuch as the treasury department treats the stockholders of a reorganized corporation, who surrender their stock, as liable to income tax if the value of the stock received is in excess of the cost of the stock surrendered, or its value on March 1, 1913, it feels bound to permit the new corporation to obtain the benefit of a revaluation of corporation assets for purposes of invested capital.[286]

Where two corporations are engaged in different branches of the same business and the certificate of incorporation of one is amended so as to change its name and increase its capital stock, which new stock is issued prior to March 3, 1917, in exchange for the stock of the two original companies, the invested capital of the corporation whose certificate has been so amended will be determined by adding to such corporation's original invested capital prior to the transaction the appreciated value (as of the date of the exchange of stock) of the assets of the other corporation the control of which had been transferred. No appreciation of value for purposes of invested capital is allowable with respect to the corporation

[285] A. R. R. 268, T. B. 41-20-1238; A. R. M. 60, T. B. 25-20-1022.

[286] A. R. M. 60, T. B. 25-20-1022.

which amended its certificate since there was no change of identity on the part of this corporation.[287] Where a corporation transfers its property to an association composed of its stockholders and the association after January 1, 1914, but prior to March 3, 1917, transfers substantially the same assets to a new corporation, the fair market value of such assets when transferred to the new corporation should be included in determining the invested capital of the latter.[288] The revaluation of assets upon a reorganization may not always result in an appreciated value. The invested capital of a corporation is measured by the original capital contribution of the stockholders and need not be reduced by any subsequent deficit in the nature of an operating loss. Likewise, depreciation and depletion of capital assets need only be applied against *earned* surplus and need not be applied against capital on *paid-in surplus*.[289] In the case of a corporation the capital of which has been impaired by losses or by depletion or depreciation not properly allowed for, a reorganization may result in a capital contribution to the new corporation smaller than the original capital contribution of the stockholders of the old corporation. In the case of such a reorganization prior to March 3, 1917, or after that date, provided the interest or control of the assets is changed, the reorganized corporation may by virtue of the reorganization be obliged in effect to reduce what would have been the invested capital of the old corporation by the amount of any such loss, depletion or depreciation. The mere change of domicile of a corporation without change as to capital and surplus does not affect invested capital even though the new corporation is an entity distinct from the old. In such case the charter issued in one state has merely been surrendered in exchange for a new charter in another state without change in the business or amount of capital and surplus and the new corporation is entitled to the same invested capital as the old.[290]

As to Values Marked Up on the Books of Account. Invested capital cannot be based upon an appraisement showing

[287] O. 872, T. B. 10-19-365; see A. R. R. 285, T. B. 42-20-1252; Sol. Op. 41, T. B. 34-20-1159. This decision is silent as to whether the corporation whose assets were appreciated for purposes of invested capital was subjected to income tax to the extent of such appreciation.

[288] Sol. Op. 41, T. B. 34-20-1159.

[289] Reg. 45, Art. 860; A. R. R. 436, T. B. 13-21-1536; letter from Treasury Department dated March 19, 1918; letter from Treasury Department dated April 14, 1916; W. T. S. 1919, ¶ 1042.

[290] A. R. R. 16, T. B. 3-20-697.

the value as of any date subsequent to the date of acquisition.[291] Therefore, if a corporation has marked up the value of any of its assets the amount by which the original book values have been so increased must be deducted. This doctrine has now been established by a leading case in the Supreme Court,[292] decided under the 1917 Law. In this case a corporation acquired ore lands in 1904 for $190,000. Extensive explorations and developments between that year and 1912 gave the lands an actual cash value of upwards of $10,000,000 in 1912, which value extended through 1917. This appreciation in value was capitalized by the issue of a stock dividend in 1912. In its 1917 invested capital the corporation included the ore lands at their appreciated value so capitalized. Invested capital was, of course, reduced to this extent by the Commissioner, and recovery of the additional tax paid as a result of the decrease of invested capital was sought in court. The contention of the corporation was that the increased value of the ore lands was "paid-in or earned surplus and undivided profits; that under the phrase "the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation" the stock issued as a dividend was fully paid for either (a) by the tangible assets including the ore properties, at their increased value, or (b) by the surrender of certificates representing the old stock of the corporation in exchange for new stock including the stock dividend. These contentions were overruled by the Supreme Court.[293]

[291] Reg. 45, Art. 831; Reg. 41, Art. 42. Letter from Treasury Department dated March 5, 1918.

[292] La Belle Iron Works v. U. S., 41 Sup. Ct. Rep. 528, 65 L. Ed. 604; T. B. 23-21-1680. See also A. R. R. 337, T. B. 50-20-1347; A. R. M. 413, T. B. 10-21-1502.

[293] The court made the following comments on the 1917 Law in this case:

"Reading the entire language of § 207 in the light of the circumstances that surrounded the passage of the act, we think its meaning as to 'invested capital' is entirely clear. The great war in Europe had been in progress since the year 1914, and the manufacture and export of war supplies and other material for the belligerent powers had stimulated many lines of trade and business in this country, resulting in large profits as compared with the period before the war, and as compared with ordinary returns upon the capital embarked. The United States had become directly involved in the conflict in the spring of 1917, necessitating heavy increases in taxation; at the same time manufactures and trade of every description were rendered even more active, and in certain lines more profitable, than before, so that the unusual gains derived therefrom formed a natural subject for special taxation. * * * A scrutiny of the particular provisions of § 207 shows that it was the dominant purpose of Congress to

All taxpayers who, in the preparation of their tax returns for 1917 and subsequent years, have used appreciated or inflated values in determining the amount of their invested capital are required to file with the collector amended returns for each of such years, in which the invested capital should be computed without the use of appreciated or inflated values. It is not required that such amended returns shall include the figures shown in the original returns which are unaffected by this decision. Only such figures as are necessary to show the

place the peculiar burden of this tax upon the income of trades and businesses exceeding what was deemed a normally reasonable return upon the capital actually embarked. But if such capital were to be computed according to appreciated market values based upon the estimates of interested parties (on whose returns perforce the government must in great part rely), exaggerations would be at a premium, corrections difficult, and the tax easily evaded. § 207 shows that Congress was fully alive to this and designedly adopted a term—'invested capital'—and a definition of it, that would measurably guard against inflated valuations. The word 'invested' in itself imports a restrictive qualification. When speaking of the capital of a business corporation or partnership, such as the act deals with, 'to invest' imports a laying out of money, or money's worth, either by an individual in acquiring an interest in the concern with a view to obtaining income or profit from the conduct of its business, or by the concern itself in acquiring something of permanent use in the business; in either case involving a conversion of wealth from one form into another suitable for employment in the making of the hoped-for gains. See Webster's New Internat. Dict., 'invest,' 8; Century Dict., 'invest,' 7; Standard Dict., 'invest,' 1.

"In order to adhere to this restricted meaning and avoid exaggerated valuations, the draftsman of the act resorted to the test of including nothing but money, or money's worth, actually contributed or converted in exchange for shares of the capital stock, or actually acquired through the business activities of the corporation or partnership (involving again a conversion) and coming in *ab extra*, by way of increase over the original capital stock. How consistently this was carried out becomes evident as the section is examined in detail. Cash paid in, and tangible property paid in other than cash, are confined to such as were contributed for stock or shares in the corporation or partnership; and the property is to be taken at its actual cash value 'at the time of such payment'—distinctly negativing any allowance for appreciation in value. * * * The provision of clause (3) that includes 'paid in or earned surplus and undivided profits used or employed in the business' recognizes that in some cases contributions are received from stockholders in money or its equivalent for the specific purpose of creating an actual excess capital over and above the par value of the stock; and, in view of the context, surplus 'earned' as well as that 'paid in' excludes the idea of capitalizing (for the purposes of this tax) a mere appreciation of values over cost.

"The same controlling thought is carried into the proviso, which relates to the valuation of patents, copyrights, trade-marks, good will, franchises, and similar intangible property. Every line shows evidence of a legis-

correct values used in the computation of invested capital and such totals as are necessary to a redetermination of the tax need be shown. Payment of the additional tax shown to be due on such amended returns must also be made at the time the returns are filed.[294]

Inventories must be valued at cost, or cost or market, whichever is lower.[295]

AS TO INADEQUATE ALLOWANCE FOR DEPRECIATION OR DEPLETION. Where the corporation has not duly marked down the value of its property subject to depreciation, or set up a depreciation reserve to provide for replacement of values lost by depreciation, from the time the property was acquired down to the beginning of the taxable year, the proper amount of depreciation suffered during that period must be computed and deducted from the value of the assets in order to reach their present value at the beginning of the taxable year.[296]

lative purpose to confine the account to such items as were paid in for stock or shares, and to their values 'at the time of such payment'; * * *

"It is clear that clauses (1) and (2) refer to actual contributions of cash or of tangible property at its cash value contributed in exchange for stock or shares specifically issued for it; and that neither these clauses, nor clause (3) which relates to surplus, can be construed as including within the definition of invested capital any marking up of the valuation of assets upon the books to correspond with increase in market value, or any paper transaction by which new shares are issued in exchange for old ones in the same corporation, but which is not in substance and effect a new acquisition of capital property by the company.

"It is clear enough that Congress adopted the basis of 'invested capital' measured according to actual contributions made for stock or shares and actual accessions in the way of surplus, valuing them according to actual and *bona fide* transactions and by valuations obtaining at the time of acquisition, not only in order to confine the capital, the income from which was to be in part exempted from the burden of this special tax, to something approximately representative of the risks accepted by the investors in embarking their means in the enterprise, but also in order to adopt tests that would enable returns to be more easily checked by examination of records, and make them less liable to inflation than if a more liberal meaning of 'capital and surplus' had been adopted; thus avoiding the necessity of employing a special corps of valuation experts to grapple with the many difficult problems that would have ensued had general market values been adopted as the criteria".

[294] T. D. 3220, T. B. 37-21-1822. Such amended returns were required by November 24, 1921. This date has now been extended to January 15, 1922. (See T. D. 3243.) As to penalties for failure to file amended returns on or before such date, see R. S. 3176. (See M. 2848; W. T. S. 1921, ¶ 985.) Collectors are not allowed to extend this period.

[295] A. R. R. 517, T. B. 22-21-1667.

[296] See Reg. 41, Art. 42; A. R. R. 384, T. B. 7-21-1456.

Such depreciation cannot be offset by any unrealized appreciation.[297] Since the law contemplates that the invested capital shall be measured by the value of the original contribution of the stockholders to the corporation, paid-in surplus representing tangible property need not be reduced by reason of depreciation. All adjustments necessary on account of inadequate or excessive depreciation should be made in connection with *earned* surplus or undivided profits. Therefore, if a corporation is properly entitled to add to its invested capital in the form of paid-in surplus an amount representing excess in value of property, over the consideration paid therefor, such paid-in surplus need not be reduced on account of depreciation of the property on which the excess value is claimed. It should be borne in mind, however, that while paid-in surplus, as indicated above, need not be reduced on account of depreciation, such adjustment must be made in *earned* surplus or undivided profits, and the computation must be based not on the cash paid or stock issued for the property but on its actual value at the time acquired for the purpose of computing the allowable addition to paid-in surplus.[298] Similar reduction must also be made in case of inadequate allowance for depletion.[299] Amounts charged off for depletion during prior years and disallowed may not, merely because of the disallowance, be restored to invested capital.[300]

Depletion, like depreciation, must be recognized in all cases in which it occurs. Depletion attaches to each unit of mineral or other property removed, and the denial of a deduction in computing net income under the Act of August 5, 1909, or the limitation upon the amount of the deduction allowed under the Act of October 3, 1913, does not relieve the corporation of its obligation to make proper provision for depletion of its property in computing its surplus and undivided profits. Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be. Where deductions for depreciation or depletion have either on the books of the cor-

297 A. R. R. 71, T. B. 18-20-906.

298 A. R. R. 436, T. B. 13-21-1536. Letter from Treasury Department dated April 14, 1919; W. T. S. 1919, ¶ 1042; O. D. 90, T. B. 1-19-129.

299 A. R. R. 517, T. B. 22-21-1667.

300 O. D. 833, T. B. 9-21-1489.

poration or in its returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.[301]

The Commissioner has issued a statement interpreting the above regulation. He states that it was the intention of the department that a corporate surplus account is not to be disturbed lightly and that no change should be made in it either by the government or by the taxpayer except upon adequate evidence that the surplus account was incorrect. Unless the taxpayer can show a state of error the government should deny a claim for an increase in the surplus shown by the taxpayer's books; conversely, before a deduction can be made from the taxpayer's surplus account, the government must show that such an adjustment is necessary to correct the account. Such proof must be in the form of affirmative evidence; it can not rest upon mere assertion or the working out of the theoretical formula. A taxpayer's corporate surplus should not be reduced by the arbitrary adjustment of depreciation and depletion for past years. Surplus accounts should, however, always be carefully scrutinized and checked up for the purpose of preventing the inclusion therein of appreciated values of property. In case of doubt in such case the burden should be cast upon the taxpayer to prove that no appreciated values were included in the surplus. A presumption should always exist that a taxpayer's books of account reflect actual facts. The burden of proof is upon any one who attempts to impugn the correctness of the books of account—upon the government if it seeks to reduce its surplus account by charging off depreciation and depletion which have not been claimed by the taxpayer and upon the taxpayer where he claims that too much depreciation and depletion have been charged off in prior years.[302] There is no warrant for reducing earned surplus because of alleged failure to charge off sufficient depreciation in the past, unless the depreciable assets of the corporation are valued on its books at the beginning of the taxable year at an amount in excess of their actual value at that time.[303] The words "actual value" mean "sound value," which

301 Reg. 45, Art. 839.

302 O. D. 1104, T. B. 46-21-1926; A. R. M. 106, T. B. 18-21-1614.

303 A. R. M. 106, T. B. 18-21-1614. See also A. R. R. 390, T. B. 9-21-1487.

is "original cost" (or value as of March 1, 1913, if applicable, including additions and betterments charged to capital account less depreciation sustained). Any action on the part of a particular taxpayer which extends the useful life of a depreciable asset beyond the normal or usual term, and any circumstance which serves to increase the salvage value of a depreciable asset, operates to justify a reduction in the normal rate of depreciation. The depreciation of an asset is arrested where it is maintained at a high standard of efficiency either by the exercise of unusual care in its use or by unusual maintenance expenditures. The exhaustion of capital through use, wear and tear has, for the purpose of computing invested capital, the same effect as an operating loss, and unless this loss is properly taken care of out of earnings in one way or another earned surplus must be adjusted in accordance with the regulations. There are two ways of taking care of this loss out of income. One is by charging ordinary repairs directly to expense and setting up a depreciation reserve against which are properly chargeable all renewals and replacements; the other is where renewals and replacements, as well as repairs, have been charged directly against gross income. Either way has the effect of reducing the amount added during the year to earned surplus. Consequently, the mere fact that no depreciation, or a minimum depreciation, has been charged as such is not sufficient reason for reducing the earned surplus where renewals and replacements sufficient to care for the decrease in value of capital assets have been charged directly to expense, or where for any other reason less than the normal rate of depreciation is properly chargeable. When a taxpayer makes this claim there are two methods of verifying it. One is by determining the plant efficiency and the other is by determining the value of the capital assets remaining. From an administrative standpoint the latter is probably more practical even though it may be said that the former is more accurate.

Many cases arise where corporations have been in existence for a long period of years, sometimes several times the ordinary estimated life of the depreciable assets, and yet those assets are today in first-class condition and worth the figure at which they are carried on the books, although no depreciation has been charged as such and no additions to capital account have been made. In such cases it is obvious that depreciation has been adequately cared for by charges to expense, although it frequently happens that it is impossible at this late date to segre-

gate and specify such charges and there is no warrant in the law or the regulations for requiring the depreciable assets in such cases to be written down below the figure at which they are carried on the books, since to do so is to reduce earned surplus twice, once through the original charge to expense (whether proper or improper) and again through an arbitrary depreciation charge set up against earned surplus for the purpose of computing invested capital. The controlling rule in this matter is stated above to the effect that adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be. *Mere failure in prior years to have written off on the books the maximum or ordinary rate of depreciation is not in itself "affirmative evidence."*[304]

AS TO LOSSES. Where a loss has taken place, and the value of the asset has not been marked down accordingly, the amount of such loss must be deducted in this adjustment. But where a loss has taken place it will be taken into account only to the extent that it has wiped out earned surplus. The amount of the original capital contributed by the stockholders is not reduced by reason of the loss, but no new surplus can be included as invested capital until the full loss chargeable against the capital account has been made good.[305] Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, except where there has been directly or indirectly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital.[306] Good will created to offset impaired capital has no effect on invested capital. Subsequent earnings must be used first to restore impaired capital, excess may be added to original investment as invested capital.[307] A corporation to which a certain amount of capital was once contributed, and which has not paid back any part thereof to its stockholders, either directly or indirectly, is allowed to claim the entire amount originally contributed as invested capital, regardless of losses which may have impaired

304 A. R. M. 106 explained, T. B. 30-21-1748.

305 A. R. R. 436, T. B. 13-21-1536. Letter from treasury department dated March 19, 1918; Reg. 45, Art. 860.

306 Reg. 45, Art. 860; A. R. R. 436, T. B. 13-21-1536.

307 O. D. 82, T. B. 1-19-121.

such capital, provided the corporation has no surplus against which the loss can be charged. In other words, a corporation which has a deficit instead of a surplus may disregard the deficit in the computation of its invested capital. Losses which must be taken into consideration under this adjustment are those which have been actually sustained. The mere depreciation in market value of assets is not considered to be a loss impairing invested capital. Thus, stock of other corporations may have been purchased at par and at the beginning of the taxable year may have a market value of only 75. Nevertheless, until the stock is sold, it may for purposes of invested capital be carried at its original cost, and if the corporation has marked the value down to market, it may restore the value to original cost. On the other hand, such marking down of assets to market (except in the case of dealers who inventory their stock) does not create a loss which may be deducted in computing the net income. In the case of dealers who inventory their stock, the inventory value would govern and the cost value cannot be restored.

ALLOWANCE FOR AMORTIZATION UNDER MUNITION MANUFACTURER'S TAX. The munition manufacturer's tax was laid upon the entire *net profits* actually received or accrued, from the sale or disposition of specific munitions, and it was provided in Section 302 "That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such articles manufactured within the United States, the following items: * * * (f) A reasonable allowance according to the conditions peculiar to each concern, for amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants." It is apparent from this language that the amortization allowance in question was authorized for the purpose of computing "net profits," not "net income." The right to make a deduction for amortization in computing net income for the income tax did not exist and was repeatedly denied by the treasury department prior to the passage of the Revenue Act of 1918. It is to be noted further that the taxes imposed by Title II of the Revenue Act of 1917 and Title III of the Revenue Act of 1918 were explicitly laid upon "net income," and were in a variety of ways impressed with the stamp and character of an income rather than a munition manufacturer's tax. They are in no sense mere continuations or expansions of the tax imposed by Title III of the Revenue Act of 1916. It follows,

therefore, that the deduction for amortization under the munition manufacturer's tax law was not allowed for income tax purposes and should not now be permitted to affect the surplus or any other element entering into the "invested capital" employed for purposes of the war-profits and excess-profits taxes. In ruling upon a particular case the treasury department stated: "This conclusion is supported by the character of the amortization allowance in question. It was in many respects quite dissimilar from the depreciation and depletion allowances. It was not based upon the fact that plant and equipment acquired in the year 1916 or earlier for the manufacture of munitions, actually depreciated in use or market value during the taxable year 1916. There was in general no such depreciation in value or impairment of useful life. Account was taken 'of the exceptional depreciation of special plants' but the principal allowance was 'for the amortization *of the values* of buildings and machinery,' whether those values increased or decreased in the immediate future. The principal amortization allowance looked to the establishment of a special fund to recoup exceptional war costs when war uses had ceased; it did not imply that there had been or would be any immediate impairment of physical assets, such as is covered by the depletion allowance, or any immediate exhaustion, wear, tear or obsolescence in excess of the amount covered by the depreciation allowance. It was, as stated, a special allowance peculiar to this tax, designed possibly to moderate the (then) exceptionally high rates of the munition manufacturer's tax."[308]

As to Inadmissible Assets. The adjustment by way of reduction of invested capital which must be made with respect to inadmissible assets is indicated in an earlier paragraph on that subject.[309] In the case of a corporation which has no borrowed money the reduction will equal the value of the inadmissible assets. In case the corporation has borrowed money the amount to be deducted is arrived at by deducting such proportion of the invested capital (excluding borrowed capital) as the proportion of inadmissible assets is to the total of inadmissible and admissible assets.[310] Under the 1917 Law adjustments for inadmissible assets were made on the theory that the borrowed money was used to purchase or carry the inadmissible assets and

[308] Letter from treasury department dated August 13, 1919; W. T. S. 1921, ¶ 763; T. B. M. 56, T. B. 15-19-452.

[309] See p. 1079.

[310] Revenue Acts of 1918 and 1921, § 326 (c).

only the excess of such assets over the borrowed money was deducted from invested capital. Under the present law, the adjustment seems to be on the theory that capital, surplus and borrowed money are represented by the inadmissible assets in proportion to the amount that each bears to the aggregate capital, surplus and borrowed money.

Adjustments Due to Changes in the Taxable Year. After the invested capital has been ascertained as at the beginning of the year certain adjustments may be necessary to ascertain the average invested capital during the year, which is the amount contemplated by the law.[311] The invested capital as of the beginning of any period of one year or less should be adjusted by an appropriate addition or deduction for each change in invested capital during the period. The amount so added or deducted in each case is the amount of the change averaged for the time remaining in the period during which it is in effect.[312] The fraction used in finding such average is the number of days remaining in the period (including the day on which the change occurs) over the number of days in the period. Thus, if a return is made for the calendar year ending December 31, 1918. and if $100,000 of additional capital was paid in on February 17. 1918, this addition to the invested capital is in effect for 318 days, and the amount to be added to the invested capital as of the beginning of the year would be 318/365 of $100,000 or $87,-123.29. If $50,000 of this amount was withdrawn on October 31, 1918, the amount to be deducted would be 62/365 of $50,000, or $8,493.15.[313]

311 Revenue Acts of 1918 and 1921 § 326 (d).

312 The 1917 Law provided that the invested capital should be "averaged monthly" but the treasury department instead of adopting a monthly average required the invested capital to be averaged from the day on which the change took place. (See form 1103 for 1917, Schedule D.) Under that law the following rules were made for ascertaining the average invested capital: (a) Add the capital for each of the several months during which no change occurs, and the average capital (ascertained as provided in subdivision (b) above) for each month in which a change occurs and divide the total by the number of months in the year or period. (b) To ascertain the capital for any month in which a change occurs multiply the capital as of the first day of the month by the number of days it remains constant and the capital after each change by the number of days (including the day on which the change occurs) during which it remains constant, add the products and divide the sum by the number of days in the month. (Reg. 41, Art. 43.)

313 Reg. 45, Art. 853. Adjustments for 1920—a leap year—should be made on the basis of 366 days. (O. D. 822, T. B. 8-21-1473.)

Dividends Paid from Surplus. The law expressly provides that any distribution of dividends made during the first 60 days of the year shall be deemed to have been made from the earnings or profits accumulated during the preceding taxable years.[314] A dividend other than a stock dividend affects the computation of invested capital from the date when the dividend is payable and not from the date when it is declared, except that where no date is set for its payment the date when declared will be considered also the date when payable. For the purpose of computing invested capital a dividend paid after the expiration of the first 60 days of the taxable year will be deemed to be paid out of the net income of the taxable year to the extent of the net income available for such purpose on the date when it is payable. The method of determining available net income is stated in the next paragraph. The surplus and undivided profits as of the beginning of the taxable year will be reduced as of the date when the dividend is payable by the entire amount of any dividend paid during the first 60 days of the taxable year and by the amount of any other dividend in excess of the current net income available for its payment. In the case of a dividend paid during the first 60 days of a taxable year which exceeds in amount the surplus and undivided profits as of the beginning of the taxable year the excess will be deemed to be paid out of earnings of the taxable year available at the date when the dividend is payable, and to the extent that such earnings are insufficient it will be deemed to be a liquidation of paid in capital or surplus. From the date when a dividend is payable the amount which the several stockholders are entitled to receive will be treated as if actually paid to them, whether or not it is so paid in fact, and the surplus and undivided profits, either of the taxable year or of the preceding years, will in accordance with the foregoing provisions be deemed to be reduced as of that date by the full amount of the dividend. Amounts paid to stockholders in anticipation of dividends, or amounts withdrawn by stockholders in excess of dividends declared, will in computing invested capital have the same effect as if actually paid as dividends.[315] Where a corporation issues interest-bearing notes to its stockholders in lieu of a cash dividend, invested capital should be reduced as of the date of the

[314] Revenue Act of 1918, § 201 (e). This provision will not be in effect after December 31, 1921, because of the repeal of the excess-profits tax (Revenue Act of 1921, § 201 (f)).

[315] Reg. 45, Art. 858. See paragraphs above "amounts paid into or left in business," and "dividends credited to stockholders," p. 1070.

notes, provided the dividend was not declared from current earnings.[316] It is contemplated that a dividend must not affect the computation of invested capital, except from the date when the dividend is payable. The expression "except where no date is set for its payment the date when declared will be considered also the date when payable" assumes that the corporation has resources to pay and does immediately intend to pay. When the corporation can conveniently pay the dividend so declared is a matter of administrative decision by the officers of the company and until such decision, as a condition precedent, is reached there is, in effect, no dividend to be paid and no reciprocal right on the part of stockholders to immediately exact payment.[317]

METHOD OF DETERMINING AVAILABLE NET INCOME. Whether at the time of any payment made during the taxable year there is sufficient income of the taxable year available for such payment, or whether the surplus or undivided profits as of the beginning of the taxable year must be reduced by the amount of such payment, will be determined according to the following principles:

(1) The aggregate amount of earnings of the taxable year available for all purposes up to any given date will be determined upon the basis of the same proportion of the net income for the taxable year (as finally determined for the purpose of income and excess-profits taxes) as the part of the year already elapsed is of the entire year, unless the corporation shows from its books or other records that a greater proportion of its earnings for the year was available on such date. A fairly accurate informal approximation of monthly earnings, made for the use of the officers of a corporation which did not close its books each month is insufficient to overthrow the general presumption in favor of the average or prorating method of ascertaining whether at the time of any payment made during the taxable year there is sufficient income of the taxable year available for such payment.[318]

(2) The aggregate amount available will be deemed to be applied for the following purposes in the order in which they are stated: (a) accrued federal income and war-profits and excess-

[316] O. D. 1070, T. B. 42-21-1876; A. R. R. 356, T. B. 52-20-1366; A. R. R. 102, T. B. 21-20-963.

[317] A. R. R. 408, T. B. 9-21-1488. But if a dividend is credited to stockholders' accounts with an agreement that it will not be drawn against, it effects a reduction of invested capital from the date so credited. (O. D. 1006, T. B. 34-21-1786.)

[318] T. B. R. 54, T. B. 18-19-491.

profits taxes for the taxable year, and (b) dividends paid after the expiration of the first 60 days of the taxable year and other corporate purposes, including the purchase of outstanding stock of the corporation previously issued.[319] In some cases the above computation would be indeterminate; for instance, in any case in which the amount distributed as a dividend exceeds the earnings of the taxable year to the date of the dividend payment plus the accrued federal income and profits taxes on such earnings. In such cases the amount of invested capital for the purpose of this computation may be deemed to be the invested capital as of the beginning of the taxable year, plus any additional capital paid in during such year and minus any specific withdrawal or liquidation of capital during such year.[320]

The entire amount of federal income, war-profits, and excess-profits taxes accrued for the taxable year remains a part of invested capital for the succeeding year (since it is not deductible from gross income in returns) until the taxes become due in the succeeding year. Accrual of taxes for the taxable year does not affect invested capital for the taxable year, except to the extent that the accrual of such taxes will cause dividend payments to draw on surplus as at the beginning of the year.[321]

EFFECT OF STOCK DIVIDEND. The payment of a stock dividend has no effect upon invested capital. The distribution of a stock dividend is in effect a capitalization of current earnings or of earned surplus on hand at the beginning of the year. The capitalization of current earnings does not increase the invested capital, and the capitalization of surplus on hand at the beginning of the year does not decrease the invested capital.[322] Such items as appraised value of good will, appreciation in value of real estate or other tangible property, etc., although carried to surplus and distributed as stock dividends, can not in this manner be capitalized and included in computing invested capital. If a corporation has paid a stock dividend in excess of its true surplus, it can not be deemed to have any greater invested capital than could have been computed had no such stock dividend been paid.[323]

319 Reg. 45, Art. 857.

320 Reg. 45, Art. 857; O. D. 619, T. B. 31-20-1110.

321 O. D. 85, T. B. 1-19-124; O. D. 982, T. B. 30-21-1749.

322 T. B. R. 3, T. B. 1-19-7.

323 Reg. 45, Art. 859; T. B. R. 3, T. B. 1-19-7. See paragraph above "as to values marked up on books of account," p. 1086.

EFFECT OF LIQUIDATING DIVIDEND. An amount taken from capital or paid-in surplus to meet dividend requirements is deemed a liquidation of capital to that extent and necessitates a reduction in the invested capital.[324] Thus, if a company pays a dividend declaring it to be out of earnings accumulated prior to March 1, 1913, and the excess of depletion allowable for 1917 upon the basis of the value of the company's property as of March 1, 1913, over the depletion actually estimated on the basis of cost, exceeds the dividend payment, the dividend payment will nevertheless be held to constitute an impairment of invested capital, even though the appreciation in value as of March 1, 1913, was converted into cash and reflected on the company's books during the current year. This appreciation, although it may have taken place prior to March 1, 1913, was not income until realized in the taxable year.[325] Under the excess-profits tax the earnings of the taxable year are not to be included in earned surplus and undivided profits, and the appreciation, therefore, can not be taken into consideration to reduce or affect the impairment of invested capital occasioned by the dividend payment.[326]

INCREASE OF CAPITAL STOCK. If the capital stock is increased during the taxable year, the invested capital will be considered to have been increased from and after the dates on which the cash or property for which such stock is issued are paid in.[327]

REDUCTION OF CAPITAL STOCK. If the capital stock is reduced during the year, the invested capital will be considered to be reduced accordingly from and after the dates on which the assets representing such reduction of capital stock are paid to the stockholders.[328] The mere reduction of the authorized capital without a distribution of the assets will not affect the invested capital.

PAYMENT OF PRECEDING YEAR'S EXCESS-PROFITS TAX. The amounts payable on account of income and excess-profits taxes for any year may be included in computing surplus and undivided profits for the succeeding year only for the proportionate part of the year represented by the period of time between

[324] O. 942, T. B. 26-19-598.

[325] Baldwin Locomotive Works v. McCoach, 221 Fed. 59. See chapters 19 and 33.

[326] A. R. M. 51, T. B. 20-29-43.

[327] See p. 1096.

[328] See p. 1096.

the close of the taxable year and the date or dates upon which such taxes become due and payable.[329] The date when the 1918 taxes were *actually* paid has no bearing on the computation of the invested capital of a corporation for the year 1919, inasmuch as the controlling factor is the date when such taxes were due and payable, and not the date when they were actually paid. In other words, the amount of each installment of the tax for 1918 will remain a part of the invested capital for 1919 until such installment is due and payable, and when such installment is due, an adjustment should be made in the nature of a reduction of the book value of assets.[330] Income and excess-profits taxes are deemed to have been paid out of the net income for the taxable year for which such taxes are levied and it is immaterial whether or not a reserve was set up for such taxes and if set up, whether such taxes when paid have actually been charged against such reserves.[331] It seems immaterial whether or not sufficient earnings of the current year were on hand when such taxes were actually paid. In the case of corporations having a *fiscal* year, the federal income and excess-profits taxes for the taxable year 1918 will, for the purpose of computing invested capital for the taxable year 1919, be deemed to become due and payable as follows: (a) As to such amounts as became due and payable prior to February 25, 1919, under the Revenue Act of 1916, such law shall govern; (b) In all other respects the Revenue Act of 1918 shall govern except that the installments which would become due prior to February 25, 1919, shall be deemed to become due and payable on that date; (c) Any amounts which became due and payable under the Revenue Act of 1916 prior to February 25, 1919, shall, so far as possible, be deemed to cancel the earlier installments payable under the Revenue Act of 1918.[332]

[329] Reg. 45, Art. 845; T. D. 2791.

[330] Letter from treasury department dated September 22, 1919; W. T. S. 1921, ¶ 785.

[331] Reg. 45, Art. 845; T. D. 2791; O. D. 222, T. B. 11-19-392.

[332] T. D. 2931; Reg. 45, Art. 845 (a); A. R. R. 81, T. B. 45-20-1299. See Revenue Acts of 1918 and 1921, § 250; Revenue Act of 1916, § 14 (a). Under the Revenue Act of 1916, in the case of a fiscal year corporation, return was due within 60 days after the close of the fiscal year and tax was due within 105 days after the last due date of the return (not after the date of filing), hence, for the fiscal year ended August 31, 1918, the return was due on or before October 30, 1918, and the tax on or before February 12, 1919, or on or before the 165th day after August 31, 1918. The provisions of the above ruling (Reg. 45, Art. 845 (a)) apply solely for the purpose of computing invested capital and do not

Where a corporation has filed a claim for assessment of its 1918 tax by reference to representative corporations and has made payments on the basis of 50% of the net income, the claim not having been acted upon when its 1919 return is due, the invested capital for 1919 should be adjusted on the basis of the tax payments actually made, subject, however, to readjustment when the correct amount of tax for 1918 is determined.[333]

EFFECT OF ADDITIONAL ASSESSMENT. The rule stated in the previous paragraph is in general applicable to additional assessments. It is the essence of any system of accrued accounting that items of income and outgo be estimated as they accrue and that the proper entries be made upon the books at that time. The books for any fiscal period are deemed to clearly reflect the history of that period and are not changed even though subsequent events demonstrate that certain accruals, to a minor degree, were incorrectly estimated. The necessary adjustments to correct such errors are made in the current accounts. It is only where major adjustments are necessary that it is good accounting practice to make adjustments for past errors in the surplus account. For these reasons it has been recommended that additional assessments of income and excess-profits taxes, for prior years which are relatively small or unimportant be considered paid from current earnings; but that where the additional assessment is relatively large and important such assessment be considered a liability of the taxable year in question and that the necessary adjustments of the surplus account be made. In such cases the phrase "due and payable" means the due date for taxes of the taxable year and not the date fixed for

affect the provisions of T. D. 2797 in regard to the time and manner of paying taxes where corporations have filed returns for fiscal years ending in 1918. The rule stated in the text is illustrated as follows. For example, a corporation whose fiscal year ended August 31, 1918, is assessed a total income and profits tax under the 1917 Law of $250,000 and an additional tax under the 1918 Law of $110,000. The total tax of $360,000 would for the purpose of computing invested capital, be deemed to become due and payable as follows: February 12, 1919, $250,000; May 15, 1919, $20,000; August 15, 1919, $90,000. If, assuming the same taxes, the fiscal year ended September 30, 1918, the total tax would for the purpose of computing invested capital, be deemed to become due and payable as follows: February 25, 1919, $90,000; March 15, 1919, $90,000; June 15, 1919, $90,000; September 15, 1919, $90,000. (See letter from treasury department dated October 27, 1919; W. T. S. 1921, ¶ 784.)

[333] O. D. 410, T. B. 11-20-788.

the payment of the additional assessment. In all cases in which the additional assessment is less than 5% of the original assessment or is less than $5,000 it will be considered paid out of current earnings and no adjustment of invested capital need be made.[334]

EFFECT OF REFUND. Where a taxpayer made an overpayment of income taxes for the year 1917 in 1918, which amount was refunded to him in the year 1921, it is held that the amount of tax overpaid for 1917 and refunded may be included in the invested capital of the taxpayer for 1918 and subsequent years.[335]

REDUCTION OF RESERVES. If payments are made out of any reserves set up on the books of the company, which reserves are in fact a part of the surplus and have been included as invested capital at the beginning of the year, the invested capital is not reduced by such payments, if the payments are such as may properly be charged against the net income for the current year under the law. Thus, if a corporation is carrying a self-insurance reserve and sustains a loss in 1919 due to fire or other casualty, it may deduct that loss against the 1919 income although on its books the loss may be charged against the reserve. In such case the reserve is not reduced for purposes of invested capital. If, however, payment is made out of the reserve for any expenditure which is not deductible from the 1919 income and does not represent investment in a new asset the reserve is reduced for purposes of invested capital.[336]

Invested Capital for Fractional Part of Year. In the case of a corporation making a return for a full year of 12 months, its invested capital for the year is the average invested capital for the year. In the case of a corporation making a return for a fractional part of a year, its invested capital for such period is the same fractional part of the average invested capital for such period.[337] To illustrate: A corporation was organized July 1, 1918, and makes a return for the six months ending December 31, 1918. The invested capital consists of $100,000 paid in on July 1 and $100,000 paid in on October 1. The average invested capital for such period would be $100,000 plus 92/184 (not 92/365) of $100,000 or $50,000, a total of $150,000. The in-

[334] T. B. M. 51, T. B. 12-19-411.

[335] O. D. 1079, T. B. 43-21-1889.

[336] See Reg. 45, Arts. 884, 860.

[337] For the purpose of § 311 (a) (2) of the 1918 Law it is the full average invested capital for the period.

vested capital for the period for the purpose of the tax would, however, be 184/365 of $150,000, or $75,616.44.[338]

Invested Capital for Prewar Period. The invested capital for the prewar period should in general be determined in the same manner as for the taxable year.[339] The determination of invested capital for the prewar period is important for purposes of computing the war-profits credit.[340] Since the war-profits tax is only temporary, being in force for the year 1918, except in the case of corporations deriving a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive,[341] the following discussion of invested capital for the prewar period relates only to the war-profits tax imposed on all corporations for the year 1918 and on corporations deriving incomes from government contracts, as above indicated, for subsequent years.

Adjustment for Assets Differently Valued in Prewar Invested Capital.[342] In any case in which as a result of a reorganization or for any other reason any asset in existence both during the taxable year and any prewar year is included in computing the invested capital for the taxable year, but is not included in computing the invested capital of such prewar year, or is valued on a different basis in computing the invested capital for the two years, the difference resulting therefrom may not be included in determining the difference, 10% of which is added to or deducted from the war-profits credit. In any such case the corporation is required to make the readjustment required by the statute, and submit with its return a full statement of the difference in such valuations and of the facts which give rise to such difference.[343] This provision of the statute may operate in a case where a corporation was reorganized after the beginning of the prewar period, or consolidated with another, as a

338 Reg. 45, Art. 855, 856. In computing the tax under a return for a fractional part of a period the same purpose may sometimes be more readily effected by using the full invested capital and taking a fractional part of the result, as in schedule III of form 1120. In schedule IV of the same form, however, the fractional part of the full average invested capital for the period should be used.

339 Reg. 41, Art. 51; as to affiliated corporations see p. 1132.

340 Revenue Act of 1918, § 311.

341 Revenue Act of 1918, § 301 (c).

342 The Revenue Act of 1917 was silent on this subject, and such adjustment was less important under that law.

343 Revenue Act of 1918, § 330; Reg. 45, Art. 934.

result of which good will, patents or other assets owned during the prewar period may have been capitalized for the first time, or the capital value of which may have been increased.

REORGANIZATION AFTER JANUARY 1, 1911. In the case of the reorganization, consolidation or change of ownership after January 1, 1911, of a trade or business carried on during the taxable year by a corporation, the corporation will, for the purpose of determining invested capital for the war-profits credit, be deemed to have been in existence prior to that date and the net income and invested capital of such predecessor for all or any part of the prewar period up to the organization of the corporation now carrying on such trade or business will be deemed to have been the net income and invested capital of such corporation. If the predecessor trade or business was carried on by a partnership or individual, the corporation must make its return of the net income and invested capital of such trade or business as nearly as may be in the same manner as if such trade or business had been carried on by a corporation. It should submit with its return a statement setting forth (a) the manner in which such trade or business was carried on and (b) the points, if any, in which the provisions of the statute and of the regulations are not fully applicable to the determination of the net income or invested capital of the predecessor trade or business for the prewar period. In no case shall the deduction from gross income for salary or compensation for personal services exceed the salaries or compensation customarily paid at that time by corporations or partnerships of similar size and standing engaged in similar trades or businesses for similar services under like responsibilities.[344]

[344] Revenue Act of 1918, § 330; Reg. 45, Art. 932. This provision is not contained in the present law. The 1917 Law contained a similar provision applicable to "a trade or business carried on by a corporation, partnership, or individual, although formally organized or reorganized on or after January 2, 1913, which is *substantially a trade or business* carried on prior to that date." A company owning a mill, some real estate and some water power rights and with two outstanding issues of bonds, became insolvent and stopped operations in June, 1914. The corporation was declared bankrupt in September, 1914. In March, 1915, a sale under the first mortgage was held and the property acquired on behalf of the first mortgage bondholders and a new corporation formed by the first mortgage bondholders which took over the assets of the old corporation from the trustee, the stock of the new corporation being divided among the first mortgage bond owners in proportion to their ownership of bonds. It was held that the business of the new company was substantially a continuation of the trade or business carried on by

In the case of a reorganization, the new corporation is required to base its invested capital on the adjusted balance sheet of its predecessor as of the date of reorganization. Appreciation in the value of the assets so transferred from the old organization to the new can not be included in the invested capital of the new corporation. The statute, however, does not prohibit the treatment of the date of reorganization as the beginning of a new taxable year. Consequently, it does not require the exclusion from the invested capital of the new corporation of surplus and undivided profits earned between the beginning of the then taxable year of the predecessor corporation and the beginning of the taxable year of the new corporation.[345]

AVERAGE INVESTED CAPITAL FOR PREWAR PERIOD. The average invested capital for the prewar period is determined by first ascertaining the average invested capital for each year during the whole of which the corporation was in existence and averaging the sums so obtained.[346]

Invested Capital of Insurance Companies. The reserve funds of insurance companies the net additions to which are deductible from gross income[347] can not be included in computing invested capital.[348] The like reserve funds of insurance companies

its predecessor because of the fact that the product manufactured by the new company was sold under the same trade name and produced in the same location, although the new company had made extensive changes in the water power and machinery, had installed at considerable expense some new machinery, had changed practically the entire system of production, had formed new banking connections, and had acquired additional funds through these connections for the purpose of securing additional working capital. (A. R. R. 221, T. B. 32-20-1124.)

345 T. B. R. 2, T. B. 1-19-137.

346 Revenue Act of 1918, § 326 (d).

347 Revenue Act of 1918, § 234.

348 Revenue Act of 1918, §§ 325, 326 (b); Reg. 45, Arts. 870, 569, as amended by T. D. 3153, T. B. 17-21-1600. Under the 1917 Law it was held that the invested capital of a mutual insurance company would be deemed to consist of the sum of (1) any surplus or contingent reserves maintained for the general use of the business, plus (2) any legal reserves the net additions to which are included in the net income subject to the tax, making due allowance for inadmissible assets as required by the law. The invested capital of a stock insurance company was deemed to consist of its capital stock, paid-in or earned surplus and undivided profits, subject to the restrictive provisions regarding inadmissible assets, and computed in accordance with the provisions applying to the computation of invested capital of corporations. (Reg. 41, Art. 65.)

other than life insurance companies may be included in computing invested capital.[349]

Invested Capital of Foreign Corporations. Inasmuch as the war-profits and excess-profits tax in the case of a foreign corporation is not based on the invested capital of the corporation, but such corporations are assessed on the basis of representative corporations,[350] the rules for determining invested capital[351] have no application to foreign corporations. For the same reason, when rendering a return of income on Form 1120 for a foreign corporation, no entry of invested capital should be made thereon.[352]

Invested Capital of Domestic Corporations Deriving Substantial Income from Possessions of the United States. The Revenue Act of 1921 provides for the taxation of domestic corporations only with reference to income from sources within the United States. If such domestic corporations derive 80% of their gross income for a three year period preceding the close of the taxable year from sources within a possession of the United States (excluding the Virgin Islands) and 50% of their gross income for such period from the active conduct of a trade or business within a possession of the United States,[353] such corporations are taxable under the Revenue Act of 1921 in the

349 Reg. 45, Art. 870, as amended by T. D. 3153, T. B. 17-21-1600. See also Reg. 45, Art. 549, as amended by T. D. 3153. This ruling was made under the 1918 Law. Life insurance companies are now taxed in a different manner for 1921 and insurance companies other than life insurance companies and mutual insurance companies are now taxable in a different manner for 1922. Chapter 11 should be consulted in this connection.

350 See Revenue Acts of 1918 and 1921, §§ 327, 328.

351 Revenue Acts of 1918 and 1921, § 326; Reg. 45, Arts. 831-870.

352 Reg. 45, Arts. 871, 962. The 1917 Law provided that the invested capital of a foreign corporation, or a foreign partnership or nonresident alien, would be determined by taking that proportion of the entire invested capital, as defined and limited by the law, which the net income from sources within the United States bore to the entire net income. (Revenue Act of 1917, § 207; Reg. 41, Art. 48.) As a practical matter the treasury department found it extremely difficult to ascertain the invested capital of foreign corporations in this manner, and ruled that where upon application by a foreign taxpayer it was found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income," assessment would be made under § 210 of that law (Reg. 41, Art. 52) as a case in which the invested capital could not be satisfactorily determined.

353 Revenue Act of 1921, § 262.

same manner as has been stated of foreign corporations in the preceding paragraph.[354]

War-Profits Credit.[355] In the case of all domestic corporations the war-profits credit includes a specific exemption of $3,000.

[354] Revenue Act of 1921, § 327 (b).

[355] Revenue Act of 1918, § 311; Reg. 45, Arts. 781-785. The war-profits credit, in that it depends to some extent upon income and invested capital in the prewar period, corresponds somewhat to the deduction allowed under the 1917 Excess-Profits Law. Under that law, except when the income for the prewar period could not be satisfactorily determined, or was low, or when there was no such net income, the deduction in the case of a *domestic corporation* consisted of a sum of (1) an amount equal to the same percentage of invested capital for the taxable year which the average amount of net income during the prewar period was of the invested capital for the prewar period (except 7% was used if such percentage was less than 7%, and 9% was used if such percentage was more than 9%, and 8% was used if a corporation was not in existence during at least one calendar year during the prewar period). To this sum was added the sum of $3,000. The same deduction was allowed *domestic partnerships and citizen or residents* except that such taxpayers received a specific exemption of $6,000. *Foreign corporations* and partnerships and nonresident aliens received no specific exemption (see Reg. 41, Art. 21; Revenue Act of 1917, §§ 203-205). Where a corporation was not in existence during the prewar period the Commissioner had no discretion, but was obliged to compute a deduction of 8% (A. R. R. 499, T. B. 20-21-1644). In the case of a trade or business formally organized or reorganized on or after January 2, 1913, but which was substantially a continuation of a trade or business carried on prior to that date, the corporation or partnership was deemed to have been in existence, or the individual was deemed to have been engaged in trade or business, prior to that date; and for the purpose of computing the deduction, the net income and invested capital of the predecessor was deemed to be the net income and invested capital of the present owner for the prewar period. (Reg. 41, Art. 22.) When the average amount of income for the prewar period could not be satisfactorily determined, the deduction allowed under the 1917 Law consisted of an amount equal to the percentage of invested capital for the taxable year which the average deduction (determined as above indicated, without including the specific exemptions of $3,000 or $6,000) for the taxable year of representative corporations, partnerships or individuals was of their average invested capital for such year, plus $3,000 in the case of a domestic corporation, and $6,000 and in the case of a domestic partnership or citizen or resident. The same computation of the deduction was used where the net income for the prewar period was low or where there was no net income for the prewar period. In any of the above cases the taxpayer claiming the benefit of such a deduction was required to file a claim in abatement of the amount by which the tax assessed on the 7% basis exceeded the tax upon the basis of the deduction finally determined, and payment of the amount covered by the abatement claimed was not required until the decision thereon. The Commissioner might, however,

MINIMUM WAR-PROFITS CREDIT. In all cases the minimum war-profits credit is an amount equal to 10% of the invested capital for the taxable year plus the specific exemption. This minimum exemption is allowed to any corporation which had no net income for the prewar period or whose net income for the prewar period was less than 10%.[356]

WHERE INCOME IN PREWAR PERIOD WAS MORE THAN 10%. If the net income of a corporation for the prewar period was more than 10%, the average net income, determined by taking the total net income for the prewar period and dividing by the number of years during the whole of which the corporation was in existence, even though there may have been no net income for one or more of such years, will be taken as a part of the war-profits credit. To this is added or deducted (depending upon whether or not the capital has been increased or reduced) 10% of the difference between the average invested capital for the prewar period and the invested capital for the taxable year.[357]

CORPORATIONS WHICH HAD NO PREWAR PERIOD. If a corporation had no prewar period, the war-profits credit is the specific exemption plus an amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer (but not less than 10% of the invested capital of the taxpayer for the taxable year). Such average percentage is to be determined by the Commissioner on the basis of data contained in the excess-profits tax returns filed under the Revenue Act of 1917. As such average percentage had not been determined and published at least thirty days prior to the time when the 1918 return of the taxpayer was due, such return was made up by using 10% as a deduction, but such average percentage when determined is to be used by the Commissioner in fixing the correct amount of the tax.[358] The average percentages of prewar income to prewar invested capital of general classes of corporations, grouped as to trades or businesses, has now been published and is known as the

require a bond covering the payment of such difference. (Reg. 41, Arts. 23, 49.) The provisions of this article were waived in A. R. R. 547, T. B. 27-21-1718.

356 Reg. 45, Art. 782.

357 Reg. 45, Art. 781; see illustration No. 1, Appendix to 1920 edition.

358 Revenue Act of 1918, § 311 (c).

"Median."[359] This median is final and relief will not be granted by way of special assessment with reference to representative corporations[360] merely for the reason that the application of the median does not fix the relief to which taxpayers think they are entitled.[361] If the majority of the stock of any corporation which had no prewar period is owned or controlled at any time during the taxable year by a corporation which had a prewar period this provision does not apply and the war-profits credit will consist of the sum of the specific exemption of $3,000 and an amount equal to 10% of the corporation's invested capital for the taxable year.[362]

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. In the case of a corporation which had no prewar period and 50% or more of whose gross income consists of gains, profits, commissions, or other income derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, the war-profits credit will consist of the sum of the specific exemption and an amount equal to 10% of the invested capital for the taxable year.[363]

APPORTIONMENT OF WAR-PROFITS CREDIT IN CASE OF CORPORATION REPORTING FOR PART OF YEAR. If a return is made for a period of less than twelve months, the amount equal to the average net income for the prewar period plus or minus 10% of the difference between the average invested capital for the prewar period and the invested capital for the taxable year will be reduced to the same proportion thereof as the number of months in the period is of twelve months.[364]

FISCAL YEAR CORPORATIONS. In calculating a corporation's war-profits credit in the case of a fiscal year the starting point

359 See the Appendix to the 1920 edition. The average known as the median is by the statute required to be used. It is not an arithmetical average, but is found by taking the middle figure of a series or array of figures arranged in order from the lowest to the highest.

360 Under §§ 327-328.

361 A. R. R. 36, T. B. 10-20-783.

362 Revenue Act of 1918, § 311 (d); Reg. 45, Art. 784.

363 Revenue Act of 1918, § 311 (d); Reg. 45, Art. 784. It should be noted that this provision applies to all corporations which had no prewar period and one-half of whose income is derived from government contracts or subcontracts. In § 327 of the law, the restriction is limited to cases where the government contracts provided for payment on a cost-plus basis. See p. 1119.

364 Reg. 45, Art. 781. The same result is reached in schedule IV of return form 1120 by computing the war-profits credit for a full year and taking a fractional part of the result.

for each year is the beginning of the fiscal year ending in 1911, 1912 and 1913, respectively, and the invested capital should be ascertained as at those dates. To these sums should be added any contributions of capital between the beginning of each such fiscal year and January 1, 1911, 1912 and 1913, respectively, and corresponding deductions should be made in respect of any dividends and any refunds of capital during those respective periods. To these balances should be added a pro rata share of the earnings of the respective fiscal years, and the totals thus arrived at will be deemed to be the invested capital of the taxpayer at January 1, 1911, 1912 and 1913, respectively. Taxpayers should file with their returns copies of their balance sheets at the beginning of each fiscal year and a schedule for each year showing the adjustments made in computing the invested capital as at the beginning of each calendar year during the prewar period. Where a taxpayer has such accounting records as will enable him to prepare an accurate balance sheet showing the true surplus and undivided profits at the beginning of each one of the prewar calendar years and an accurate income account for such years, he may make the computation upon this basis and explain the method used in such details as will enable the Commissioner to determine whether such basis is proper. Where a taxpayer has not been in business during the whole of the prewar period, the above methods will be applicable to such full calendar years during the whole of which years the taxpayer was in business.[365]

Excess-Profits Credit. The excess-profits credit in the case of a domestic corporation consists of the specific exemption of $3,000 plus an amount equal to 8% of the invested capital for the taxable year.[366]

Specific Exemption. Domestic corporations are allowed a specific exemption of $3,000 to be deducted from the net income, but if the tax is computed for a period of less than 12 months the specific exemption is reduced in proportion.[367] The specific exemption of $3,000 is apportioned only in the case where a return is made covering a period of less than 12 months. In such a case the specific exemption is the same proportion of $3,000 as

[365] T. B. R. 16, T. B. 5-19-264.

[366] Revenue Act of 1918, § 312; Reg. 45, Art. 791. This is the credit still used in the present law. (Revenue Act of 1921, § 312.) But a domestic corporation taxable under § 262 is not entitled to the credit or exemption of $3,000.

[367] Revenue Acts of 1918 and 1921, § 305. See footnote 366 as to domestic corporations taxable under § 262 of the present law.

the number of months in the period is of 12 months, any fractional part of a month being counted as the number of days in such part of a month divided by 30. Thus, in the case of a corporation organized May 12, 1918, and making a return for the period ending December 31, 1918, the exemption is $1,916.67, that is, the same proportion of $3,000 as 7 20/30 months is of 12 months. This provision is inapplicable where the return is made for a full fiscal year beginning prior to January 1, 1918, and ending after that date, even though the income for such fiscal year is not subject to full taxation under the present statute. In the case of affiliated corporations only one specific exemption is allowed.[368]

Net Income. Net income for this tax is ascertained in general upon the same basis and in the same manner as for the purpose of the income tax, except as noted in this and the following paragraphs.[369] Thus, when a corporation may deduct the amount of its net operating loss for the calendar year 1919, which is in excess of the net income for the calendar year 1918, in computing net income for the calendar year 1920, the excess-profits tax is upon the net income so determined.[370] Reference to the rules for estimating income for the prewar period is given as well as the rules applying to the taxable year. Under the excess-profits tax, however, no attention need be paid to income during the prewar period but the rules for that period are given because they still apply to such corporations as by reason of deriving income from government contracts of the kind hereinbefore indicated continue to be subject to the war-profits tax if their income from such contracts exceeds the sum of $10,000 in the taxable year. Corporations are not allowed at this late date to adjust salaries paid during the prewar period, when such adjustment is made solely for the purpose of increasing the war-profits credit for the taxable year.[371] Value appreciation of property taken up on the books of the taxpayer and returned as part of his taxable income for the year in which the appreciation was written up must be excluded in computing prewar income,

[368] Reg. 45, Art. 761. On return form 1120 this apportionment is taken care of by prorating items 3 and 8 of schedule III.

[369] It should be noted that the Revenue Act of 1921 in many respects provides different rules for the calculation of gross income, the deductions, and therefore net income. Net income for the excess-profits tax imposed by the Revenue Act of 1921 is the net income as computed under that act.

[370] O. D. 928, T. B. 21-21-1655.

[371] T. B. M. 50, T. B. 12-19-410; O. D. 184, T. B. 8-19-319.

even though an income tax has been paid on it.[372] The rule that taxes are deemed to be paid out of earnings for the year for which levied, applies to any year of the prewar period as well as to the taxable year. In such cases the amount or amounts payable in a succeeding year on account of such taxes may be included in the computation of invested capital until due and payable.[373]

FOR THE YEARS 1911 AND 1912. The net income for these years is determined upon the same basis and in the same manner as provided in the 1909 Law except that the tax as imposed by that law and paid by the corporation within the year shall be included.[374] Including such taxes for the years 1911 and 1912 is a slight advantage to the corporation in that it increases the net income for the prewar period for the purpose of the war-profits credit.

FOR THE YEAR 1913. The net income for the year 1913 is ascertained on the same basis and in the same manner as provided in the 1913 Law, except that the taxes imposed by the 1909 Law on the corporation on its income for 1912 and paid by the corporation in 1913 may be included, and amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the tax imposed by the 1913 Law, must be deducted.[375]

AVERAGE NET INCOME FOR THE PREWAR PERIOD. The average net income for the prewar period is determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no net income for one or more of such years.[376] Thus, if a corporation was in existence during 1912 and 1913 but derived no income in 1912, its income for the year 1913 must be divided by two in order to ascertain the war-profits credit. But, on the

[372] T. B. M. 42, T. B. 8-19-335.

[373] See Reg. 45, Art. 845; O. D. 222, T. B. 11-19-392.

[374] Revenue Act of 1918, § 320 (a) 1; Reg. 45, Art. 801. The net income, under the 1917 Law, of corporations for the years 1911 and 1912 was computed in the same manner (Reg. 41, Art. 29). The net income of partnerships and individuals for 1911, 1912 and 1913 was determined in the same manner as for the taxable year, except that dividends from taxable corporations were deducted (Reg. 41, Arts. 31, 36).

[375] Revenue Act of 1918, § 320 (a) 2; Reg. 45, Art. 801. Under the 1917 Law taxes paid under Sections II or IV of the 1913 Law were also included; otherwise the rule was the same (Reg. 41, Art. 29).

[376] Letter from treasury department dated March 24, 1919; W. T. S. 1921, ¶ 687.

other hand, if the corporation had a deficit for the year 1912 and income for the year 1913, the amount of the deficit need not be deducted from the net income of 1913 in order to ascertain the average net income for the prewar period.[377] The three years must be used for the purpose of establishing prewar income, even though they represent a period of depression in the particular trade or business involved.[378]

FOR THE TAXABLE YEAR. Net income for the taxable year is computed upon the same basis and in the same manner as provided for income tax purposes under the income tax law.[379] The law expressly provides that the net income of a corporation which is subject to the income tax shall also be subject to the excess-profits tax. This would include income derived from the sales or dealings in the capital assets of the taxpayer,[380] but in the case of the sale of mines, oil and gas wells a limitation is placed upon the amount of the excess-profits tax to be assessed with respect thereto.[381]

377 Letter from treasury department dated February 21, 1918. As to the prewar income of affiliated corporations, see p. 1135.

378 A. R. R. 618, T. B. 39-21-1849. Special assessment by reference to representative corporations may be granted in such a case, however, if the depression constituted an abnormal condition affecting the prewar period. See p. 1119.

379 Revenue Act of 1918, § 320 (a); Reg. 45, Art. 801. See footnote 369.

380 Letter from treasury department dated February 21, 1918.

381 See p. 1038. Under the 1917 Law the net income for purpose of income tax and excess-profits tax were not identical, since for the purpose of the latter tax corporations were expressly allowed to deduct dividends. (Reg. 41, Art. 28.) Since the 1917 Law provided an excess-profits tax at lower rates on salaries than on income from a business employing invested capital, the treasury department held that where a corporation had paid its officers only nominal salaries, a reasonable allowance for salaries could be deducted for any period prior to March 1, 1918, if a satisfactory explanation was given. (Letter from treasury department dated March 11, 1918.) Under the present law there seems to be no need for rulings of this character since an excess-profits tax law has been in force for a length of time sufficient to enable corporations to adjust salaries and other items which in the past may have been merely nominal by reason of the relation of the corporation to its stockholders. The income of partnerships for the taxable year was ascertained by deducting from the net income as computed under the 1916 Law (including interest on United States obligations not exempt from excess-profits tax) (1) dividends from taxable corporations and interest paid to an individual partner upon a *bona fide* loan, but not "so-called interest upon capital." (Reg. 41, Arts. 30, 33; A. R. R. 619, T. B. 39-21-1848.) Partnerships were also allowed a reasonable deduction for salaries to individual partners for any period prior to March 1, 1918, regardless of whether a previous agreement had been made, such salaries

Exemption Granted by Merchant Marine Act. The Merchant Marine Act of 1920 provides that the owner of a vessel documented under the laws of the United States, and operated in foreign trade, shall, for each of the ten taxable years while so operated, beginning with the first taxable year ending after June 5, 1920, be allowed as a deduction in computing net income subject to the war-profits and excess-profits taxes, an amount equivalent to the net earnings of such vessel during such taxable year determined in accordance with rules and regulations to be made by the United States shipping board. No such owner is entitled to such deduction, unless during the taxable year he invests or sets aside in a trust fund for investment in the building of shipyards in the United States of new vessels of a type and kind provided by the shipping board, an amount to be determined by the secretary of the treasury and certified by him to the shipping board, equivalent to the war-profits and excess-profits taxes that would have been payable but for such deduction. At least

being taxable to the partners at the 8% rate. (Reg. 41, Art. 32.) If the deductions for salaries or interest paid to individual partners were availed of, corresponding deductions were required to be made for the prewar period (Reg. 41, Art. 34). Individuals employing merely a nominal capital were required to compute their net income for the taxable year by adding together all salaries, wages, etc., constituting income from a business with merely a nominal capital (Reg. 41, Art. 35). Individuals employing more than a nominal capital ascertained their net income for the taxable year by deducting from their net income from all sources a deduction for salaries paid to themselves and any contributions made by a trade or business (as distinguished from those made in a personal capacity). If a salary deduction was made for the taxable year, it was required to be made for the prewar period. An individual member of a partnership need not, however, include his share of the partnership profits, but must include any salary deducted by the partnership. A dealer in securities was required to include interest on United States obligations not exempt from excess-profits tax and a proportion of dividends from foreign corporations (Reg. 41, Arts. 35-41). In the case of nonresident aliens, and foreign partnerships and corporations, there was included only income from sources within the United States (Reg. 41, Art. 26). Income derived from the business of life, health, and accident insurance combined in one policy issued on a weekly premium payment plan was exempt from the 1917 Excess-Profits tax, as was also compensation to officers and employees of the United States, any state, territory, or the District of Columbia, and the income generally exempt from income tax (Reg. 41, Art. 25). An individual engaged in more than one business the income from which was taxable under different provisions of the law and regulations, might not deduct losses sustained in the one from gains or profits made in the conduct and operation of the other for the purpose of computing the excess profits tax for 1917. (A. R. M. 96, T. B. 48-20-1328.)

two-thirds of the cost of any vessel so constructed must be paid for out of the ordinary funds or capital of the person having such vessel constructed. During the period of ten years subsequent to June 5, 1920, any citizen of the United States who may sell a vessel documented under the laws of the United States, and built prior to January 1, 1914, is exempt from all income, war-profits, and excess-profits taxes imposed by the Revenue Act of 1918 that would be payable upon the proceeds of such sale, if the entire proceeds thereof are invested in the building of new ships in American shipyards, such ships to be documented under the laws of the United States and to be of a type approved by the shipping board.[382]

Assessment Without Reference to Invested Capital. In certain cases it is found difficult or impossible to determine the invested capital of a corporation. In such cases and in cases of "abnormal conditions affecting the capital or income of a corporation," without reference to the difficulty or impossibility of determining invested capital in the ordinary manner, the excess-profits tax will be computed on the basis of the returns of representative corporations engaged in a like or similar trade or business.[383] Four cases in which the tax will be so determined are enumerated in the law and are discussed in the paragraphs below.

[382] Merchant Marine Act, 1920, § 23; W. T. S. 1921, ¶ 869.

[383] Revenue Act of 1918, § 327. In many cases in which personal service classification has been claimed under the 1918 Law or assessment as a concern with merely nominal capital under the 1917 Law, these claims have been denied, but special assessment under § 210 of the Revenue Act of 1917 or §§ 327, 328 of the Revenue Act of 1918 has been granted (See Chapter 9 in connection with these cases). Sections 327 and 328 of the 1918 Law correspond to the famous § 210 of the 1917 Law which provided that when the invested capital could not be satisfactorily determined the corporation was entitled to an excess-profits deduction of an amount equal to the same proportion of its net income for the taxable year as the proportion which the average deduction (excluding the specific sum of $3,000) for the corresponding year of representative corporations bears to the total income of such representative corporations plus, in the case of domestic corporations, the sum of $3,000. This section applied also to partnerships and individuals under the 1917 Law. In determining this proportion the net incomes of representative corporations for the calendar year or for fiscal years ending in the calendar year were taken. In case the corporation whose invested capital could not be satisfactorily determined made a return for its own fiscal year the proportion determined for the calendar year ending during such fiscal year was used. (Reg. 41, Art. 24.) The rulings provided for a computation of constructive invested capital in order to apply the rates to a corporation whose invested capital could not be determined. (Reg.

ELECTION OF TAXPAYER. It has been held under the corresponding section[384] of the Revenue Act of 1917 that while a strict and literal interpretation of the language gives the treasury department the right to determine that invested capital can not be satisfactorily determined, and therefore that the taxpayer should be assessed without reference to invested capital, it is manifestly the intent of the law that the taxpayer shall have a deduction upon all the statutory invested capital which he can establish, and if in any case the taxpayer is able to show that it has statutory invested capital in excess of constructive capital found upon application of the special relief section the taxpayer should not be deprived of the right to have assessment based upon such statutory capital because there are other items of invested capital which can not be determined and which the taxpayer concedes the right of the treasury department to ignore. This rule would seem to apply under the Revenue Act of 1918 and the present law, except with regard to foreign corporations.[385]

Where Commissioner Is Unable to Determine Invested Capital. The first case is where the Commissioner is unable to determine invested capital as defined in the law. Such cases exist, for example, where the books of account of the company have not been kept in proper form or where it is impossible to ascertain the values of assets at the time of acquisition.[386] Where the books of a corporation have been carefully kept and it is possible to ascertain what amounts previously charged off as excessive depreciation may be restored, the corporation is not entitled to special assessment on the ground that the Commissioner is un-

41, Art. 18.) *Under the 1918 and 1921 Laws there is no need for constructive capital in such cases since the tax is now based upon the ratio of the amount of tax to the amount of net income of representative corporations.*

384 Revenue Act of 1917, § 210.

385 A. R. R. 209, T. B. 31-20-1111.

386 Revenue Acts of 1918 and 1921, § 327 (a). A. R. R. 636, T. B. 41-21-1865; A. R. R. 338, T. B. 51-20-1359. This rule has special application where tangible property of a value substantially in excess of the par value of the stock paid therefor is turned over to a company, but the evidence as to the exact value of such property at the date of acquisition is difficult or impossible to obtain (A. R. R. 556, T. B. 37-21-1817). The 1917 Law (§ 210) provided a method which should be followed in all cases in which the Commissioner was unable *satisfactorily* to determine the invested capital. In the language of the 1918 and the present Law the word "satisfactorily" was omitted.

able to determine invested capital or on the ground that any abnormal condition affects capital or income.[387]

INVENTIONS TURNED OVER TO CORPORATION WITHOUT CONSIDERATION. In a case in which the principal stockholder turned over, without consideration, to a close corporation an invention in respect to which a patent was subsequently granted after some litigation, it has been ruled that the company was entitled to assessment with reference to representative corporations on the ground that the value of the invention at the time turned over and before commercial development could not be satisfactorily determined. Had it been possible satisfactorily to determine such value, the proper procedure would have been to recognize such value as paid-in surplus.[388]

In the Case of Foreign Corporations. The Revenue Act of 1921 and the 1918 Law provide that, in the case of foreign corporations, the tax shall be determined without reference to invested capital as defined in the law.[389] In the case of a foreign corporation carrying on all of its business in the United States it does not seem that the law should prevent the corporation from obtaining such benefits as may accrue to it from a computation of the credits with reference to an invested capital determined in the ordinary manner, but the language of the provision that the tax shall be assessed by reference to representative corporations indicates an intent that this method of assessment shall apply to all foreign corporations, and the treasury department has so ruled.[390]

Where Stock Has Been Issued for a Mixed Aggregate of Tangible and Intangible Property. The provision of the law that the tax shall be assessed by reference to representative corporations where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds, does not apply in all cases where a mixed aggregate of tangible and intangible property has been paid in for stock or for stock and bonds, but only in such cases where the Commissioner is unable satisfactorily to determine the respective values of the several

[387] A. R. R. 599, T. B. 37-21-1823.

[388] A. R. R. 70, T. B. 17-20-882.

[389] Revenue Act of 1918, 326. See A. R. R. 397, T. B. 9-21-1486. The same rule applies to domestic corporations taxable under § 262 of the Revenue Act of 1921.

[390] Revenue Act of 1918, § 327; Reg. 45, Art. 871.

classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds respectively.[391]

Cases of Abnormal Conditions Affecting Capital or Income. In cases of abnormal conditions affecting the capital or income of a corporation, assessment without reference to invested capital is intended to operate as a remedial measure as distinguished from cases where it is difficult or impossible to determine invested capital. Such assessment is made only upon application by the corporation in cases where, upon such application, the Commissioner finds (and so declares of record) that the tax if determined without the benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without the benefit of this section and the tax computed by reference to representative corporations. This provision does not apply to any case (1) in which the tax based upon the corporation's invested capital is high merely because the corporation earned a high rate of profit upon a normal invested capital nor (2) in which 50% or more of the gross income of the corporation for the taxable year consists of gains, profits, commissions or other income derived *on a cost plus basis* from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[392] It may apply, how-

[391] Revenue Acts of 1918 and 1921, § 327 (c). This provision of the law seems to be a statutory declaration of the rule adopted by the treasury department as a matter of practice, under the 1917 Law. This rule was applied under the 1917 Law in A. R. R. 459, T. B. 15-21-1568. Under that law it was ruled that assessment would be made under § 210 of that law in cases where the Secretary was unable to determine satisfactorily the respective values of the several classes of property at the time of payment. (Reg. 41, Art. 52.)

[392] Revenue Acts of 1918 and 1921, § 327 (d). The limitation stated in (1) above is applicable to assessments under § 210 of the 1917 Law (T. B. M. 7, T. B. 1-19-119). Under the 1917 Law the following were held to be exceptional cases which warranted assessment under § 210 of that law.

(1) Where, through defective accounting or lack of adequate data, it was impossible accurately to compute invested capital.

(2) Where upon application by a foreign taxpayer the Secretary of the Treasury found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income."

(3) Long established business concerns which by reason of ultra-

ever, to a corporation deriving income from government contracts on the "per unit" basis.[393] The limitation stated in (2) above has been held to be designed to cover cases in which a contractor was assured of a profit irrespective of cost and in which the government, rather than the contractor, assumed the risk of loss. Where the unfinished work of a contractor was commandeered by the government and it was agreed that he should receive the same compensation as he would have received under the private contract, the fact that he was subsequently compensated on a cost-plus basis after the work was completed does not, in the opinion of the committee, operate to change the legal situation in this respect.[394]

The tax will not *ordinarily* be assessed under this provision of law merely because the corporation's form or manner of organization, or the limitations as to invested capital result in a greater tax than would otherwise be payable.

Referring to the legislative history of the Revenue Act of 1918, it will be noted that this provision of the statute, as enacted by the Senate, read as follows:

"(e) Where the invested capital is materially disproportionate to the net income as compared with representative corporations engaged in a like or similar trade or business because: 1. The capital employed, although a material income-producing

conservative accounting or the form and manner of their organization would otherwise be placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business.

(4) Where the invested capital was seriously disproportionate to the taxable income. Such cases it was held might arise through (a) the realization in one year of the earnings of capital unproductively invested during a period of years or the fruits of activities antedating the taxable year; or (b) inability to recognize or properly allow for amortization, obsolescence, or exceptional depreciation due to the war, or to the necessity in connection with the war of providing plant which would not be wanted for the purpose of the business after the termination of the war. (Reg. 41, Art. 52.) The uses enumerated in this article are not to be regarded as exclusive, but the class of cases therein referred to is limited to the cases enumerated or those "similar in character." (T. B. M. 58, T. B. 14-19-441.) Under the 1918 and the present law the conditions described in 1 and 2 are expressly provided for; 3 and 4 (a) will be considered as creating "abnormal conditions affecting the capital or income" within the meaning of § 327 (d) and therefore entitle the corporation to relief. The condition stated in 4 (b) no longer exists as the taxpayer is now enabled to recognize and properly allow for amortization, obsolescence or exceptional depreciation.

393 O. D. 321, T. B. 26-19-599.

394 A. R. M. 89, T. B. 45-20-1288.

factor, is very small or is in large part borrowed. 2. There are excluded from the invested capital as computed under the provisions of Section 326, intangible assets of recognized and substantial value built up or developed by the taxpayer. 3. The net income for the taxable year is abnormally high due to the realization in one year of (a) gains, profits, or income earned or accrued during a period of years or (b) extraordinary gains or profit derived from the sale of property the principal value of which has been demonstrated by prospecting or exploration and discovery work done by the taxpayer. When the tax is determined under this paragraph proper allowance shall be made for the taxes which would have been payable in prior years if the gains, profits, or income earned or accrued in such years had been taxed at the rates then applicable. 4. Proper recognition or allowance can not be made for amortization, obsolescence, or exceptional depreciation due to the present war, or to the necessity in connection with the present war, of providing plant which will not be wanted for the purpose of the trade or business after the termination of the war."

This provision was stricken out by the conference committee and in its place is inserted the vague phrase "abnormal conditions affecting the capital or income of a corporation."[395] It seems probable that the instances enumerated in the Senate bill as above quoted are contemplated by the phrase of the law as finally passed—abnormal conditions affecting the capital or income of the corporation—and that the conference committee used the broad language enacted in the statute as finally passed because of the possibility that in defining the operation of the provisions for assessment of the excess-profits tax by reference to representative corporations it would be limiting the Commissioner in the exercise of his discretion and possibly preventing him from granting relief in many cases which could not be exactly anticipated or defined by Congress at the time the law was enacted. It is a well-established principle of statutory construction that where the language of the statute is ambiguous and its meaning doubtful, the bill as introduced and changes made in the frame of the bill in the course of its passage may be resorted to upon questions of legislative intent.[396] The above

[395] This provision was in large part a statutory enactment of the treasury department's previous liberal construction of § 210 of the Revenue Act of 1917. Compare the provision with the regulation quoted in note 392.

[396] U. S. v. St. Paul M. R. Co., 247 U. S. 310, 318; Atl. C. L. R. Co. v. Riverside Mills, 219 U. S. 196, 200. See also cases cited in Chapter 47.

language of the Senate bill should be consulted in connection with applications for relief by way of assessment with reference to representative corporations.

WHERE INTANGIBLE ASSETS OF SUBSTANTIAL VALUE ARE EXCLUDED FROM ORDINARY INVESTED CAPITAL. Under the Revenue Act of 1917 relief was given to many long established business concerns which, by reason of ultra-conservative accounting or the form and manner of their organization, would otherwise have been placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business.[397] As stated in the foregoing paragraph, the fact of ultra-conservative accounting and the form and manner of the corporation's organization will not *ordinarily* entitle a taxpayer to special assessment.[398] It seems clear, however, that the Revenue Act of 1918[399] contemplates that relief be granted where such factors misrepresent a corporation's true invested capital. Thus, cases in which large sums have been spent in advertising, thus creating a good will or earning capacity far in excess of recognizable invested capital are to be regarded as cases in which there are abnormal conditions affecting invested capital.[400] A corporation, the capitalization of which did not represent or include the value of certain good will or patents actually turned over to the company and actually earning income on which the corporation was paying a tax, has been held taxable under the provisions of Section 210 of the Revenue Act of 1917.[401] A corporation which clearly shows substantial intangible value in a business with small capitalization, the success of which business is not dependent on personal services, except as may be normally required for the management of the property of any company, has been held entitled to special assessment under the Revenue Act of 1917.[402] But the mere fact that the taxpayer can not be allowed to include in statutory invested capital the full amount of good will appearing upon its books, even though such good will is less than the actual value of the good will at the time acquired, does not create such an abnormal condition as to entitle a corporation to special assessment.[403]

397 See Reg. 41, Art. 52; A. R. R. 464, T. B. 17-21-1588.

398 See Reg. 45, Art. 901.

399 § 327 (d)

400 A. R. M. 12, T. B. 2-20-679; A. R. R. 338, T. B. 51-20-1359.

401 A. R. R. 110, T. B. 20-20-945.

402 A. R. R. 332, T. B. 50-20-1348.

403 A. R. R. 599, T. B. 37-21-1823. In this case, however, the good will appearing on the books of the corporation represented a considerable

WHERE ABNORMAL PROFITS ARE THROWN INTO A SINGLE TAXABLE YEAR. The artificiality of the taxable year as a unit of time for tax purposes is generally conceded. The year is taken as a matter of necessity because the very nature of income demands that it be measured by reference to time.[404] The taxable year works fairly well as a time unit in the majority of cases. The injustices, inequalities and absurdities resulting in extraordinary cases, however, are generally conceded.[405] It is well known that one of the purposes of provision for assessment by reference to representative corporations is to provide for cases in which a hardship of this kind occurs. Such hardship may occur, broadly speaking, in one of two ways.

In the first place, it may occur when the income of the taxable year represents the "realization in one year of the earnings of capital unproductively invested for a period of years, or the fruits of activities *antedating* the taxable year."[406] The receipt by a corporation of the proceeds of a life insurance policy upon the life of the sole owner of its stock has been held to create an abnormal condition affecting the income of the corporation for the year of receipt.[407] But the realization of greater profits in the taxable year than had been realized in prior years does not in itself indicate the excess of an abnormal condition affecting the income of the taxable year, and this is particularly true as to the taxable years 1917 and 1918 when profits were due in large measure to war conditions.[408] Inefficient management during previous years followed by efficient management in the tax-

increase over the good will which had appeared upon the books of a predecessor corporation upon a reorganization, and no evidence appeared that the corporation as reorganized possessed assets tangible or intangible of greater value than the old corporation.

404 No one has income at any one point of time; he has income only by reference to a fixed period (Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904).

405 See letter of former secretary of treasury to committee on ways and means of house of representatives (66th congress, 1st session) dated November 3, 1919, in which it is said that the annual accounting period, the striking of a balance of gain or loss every twelve months, is merely an approximation resting upon convenience and fiscal necessity, and that the result shown is frequently unreal, for if a business concern makes $20,000 in 1918, loses $10,000 in 1919, and makes $5,000 in 1920, it has not earned profits of $25,000 in the three-year period, but only $15,000.

406 A. R. R. 538, T. B. 28-21-1730.

407 A. R. R. 335, T. B. 50-20-1345.

408 A. R. R. 599, T. B. 37-21-1823; A. R. R. 518, T. B. 22-21-1668.

able year does not create an abnormal condition.[409] This kind of a case was specifically provided for in the regulations issued under the Revenue Act of 1917.[410]

In the second place, it may also occur when the income of the taxable year represents temporary earnings inevitably to be reduced by then indeterminable losses inseparably connected with the production of such income. While this class of cases has nowhere been enumerated in a formal regulation, it seems to be clearly analogous in principle to the class of cases described in the above quotation and must have arisen in the case of many corporations operating under long-term, fixed-price contracts during the last few years when the cost of labor and materials was constantly rising. It might also arise in the case of a company which liquidated all its business in a particular year unless the liquidation did not result in a tax abnormally high as compared with taxes imposed upon representative concerns in the same line of business.[411]

PAYMENT OF INADEQUATE SALARIES TO OFFICERS. It has been held under the Revenue Act of 1917 that failure to pay salaries to officers, or the payment of unusually low salaries in comparison with salaries paid to the officers of competing concerns, may create an abnormality of income which will entitle a corporation to special assessment.[412]

ABNORMAL CONDITIONS AFFECTING PREWAR PERIOD. The statutory provision in regard to "abnormal conditions" is not in terms limited in its application to cases arising out of abnormal conditions affecting the capital or income of the corporation *for the taxable year*. The words "capital or income of the corporation" are general words applicable to the income or capital of any year and can not be limited by construction unless there is a clear, necessary, and irresistible implication from other parts of the statute that such a limitation should be made.[413] Furthermore, in the same subdivision Congress has in two instances specified that the income or profits referred to is that of the taxable year, although the context made that meaning clear without specification. The use of such a limiting clause

409 A. R. R. 338, T. B. 51-20-1539.

410 Reg. 41, Art. 52.

411 T. B. M. 53, T. B. 15-19-453; O. D. 969, T. B. 27-21-1720; see O. D. 395, T. B. 5-20-723 and T. B. M. 60, T. B. 15-19-454 in which it is said that the abnormal income may arise through a sale of capital assets.

412 A. R. R. 326, T. B. 47-20-1318; A. R. R. 538, T. B. 28-21-1730.

413 Faw v. Marsletter, 3 Cranch. 10, 23; U. S. v. Coombs, 12 Peters 72, 80.

in two instances and the absence of it in the third instance indicates that the words were there used without limitation. Therefore, unless there is some clear and necessary inference from the other parts of the statute, it seems evident that subdivision (d) includes cases of hardship caused by abnormal conditions affecting the capital or income for the prewar period. The prewar data is used in computing the war profits credit which may consist of (a) $3,000 plus the average net income for the prewar period with an adjustment for change in capital; or (b) $3,000 plus a percentage of the invested capital for the taxable year based on the median average established by the prewar experience of a general class of trade or business. This credit is used by concerns having no prewar period; or (c) a minimum war-profits credit of $3,000 plus 10% of the invested capital for the taxable year.[414] The minimum war-profits credit will not raise a presumption that Congress intended to include in Section 311 all relief which should be granted because of abnormal conditions existing in the prewar period, and that there is a clear and necessary inference that Congress did not intend to grant further relief of the same nature under Section 327 on account of the same conditions. The relief granted by the maximum war-profits credit and special assessment are not of the same nature. The minimum war-profits credit establishes certain rules applicable to general classes and which apply in all cases whether hardship actually exists or not. It gives relief to industries which passed through a period of depression in the prewar years. It also applies to concerns which earned less than 10% in the prewar period, even though their tax is not grossly disproportionate to that of their competitors. The "abnormal conditions" provision, on the other hand, deals not with general classes but with specific instances and grants relief in special cases according to the facts of each case where, without such relief, there would be a hardship as compared with representative concerns because of some abnormal condition affecting the capital or income of the corporation. The two provisions are of a different nature. The one would give no relief to a corporation belonging to a class which normally earned 20% if that corporation, due to some abnormal condition affecting the income of the prewar period, earned only 12% during the prewar period. Such concerns do not receive even partial relief under the minimum war-profits credit and should be granted relief under the "abnormal

414 Revenue Act of 1918, § 311.

conditions" provision.[415] It has been held under the 1917 Law that a corporation, which in 1911 commenced the erection and operation of a refinery, the building of which and the experimental operation and development work connected with which extended over several years, requiring the withdrawal from other lines of the corporation's business of a large share of its available capital, thus temporarily curtailing its earning power and reducing its profits, and thus rendering the prewar period abnormal and not a true measure of the corporation's normal average business, should be assessed under the provision requiring the excess-profits deduction to be an amount equal to the same percentage of invested capital for the taxable year which the average deduction for such year of representative corporations is of the average invested capital for such year plus, in the case of a domestic corporation, $3,000.[416] Under the Revenue Act of 1918 this kind of relief would seem to be contemplated under the general provision for assessment by reference to representative corporations on the ground that abnormal conditions affected the capital or income of the prewar period.

STATEMENT TO BE FILED. A corporation the income or capital of which is affected by abnormal conditions may make application for assessment by reference to representative corporations, which application should be attached to its return in the form of a statement setting forth in full: (a) the reasons why the tax should be so determined; (b) the facts upon which such reasons are based; (c) an exact description of each trade or business or important branch of a trade or business carried on by it; (d) a statement of the invested capital and net income for each year since the beginning of the prewar period; and (e) a statement showing the amount of gains, profits, commissions or other income derived on a cost plus basis from government contracts made after April 5, 1917, and before November 12, 1918, and showing the percentage which such income is of the total income of the corporation.[417]

Method of Assessment. Under the method of assessment by reference to representative corporations the tax will be an amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to

415 O-1000-A, T. B. 19-20-922, reversing O-1000.
416 Revenue Act of 1917, § 205; A. R. R. 104, T. B. 20-20-944.
417 Reg. 45, Art. 901.

their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax is computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.[418] Illustration: If the average net income of representative corporations is represented by $100,000: the net income in excess of the specific exemption would be $97,000. If the average tax is found to be $38,800, the rate to be applied to domestic corporations will be 38,800÷97,000 or 40%. Thus, a domestic corporation having a net income of $60,000 will deduct the specific exemption of $3,000, leaving $57,000—40% of which is $22,800, the amount of tax due under this section. But if the corporation is a foreign corporation and has an income of $60,000 the tax rate will be determined by dividing 38,800 by 100,000 which decreases the percentage to 38.8%. But this is applied to the entire net income, $60,000, making the tax due from the foreign corporation $23,280, or $480 more than that imposed on a domestic corporation with the same net income.

In the case of a corporation with a fiscal year ending in 1918, the tax is computed first as if the entire income had been earned during the calendar year 1917 and second as if such entire income had been earned during the calendar year 1918. The proper proportions of the resulting taxes are used to determine the tax for the fiscal year. "Constructive" invested capital is used only with respect to the first computation, the method with respect to the second computation being to fix a tax bearing the same ratio to net income as the taxes of representative corporations.[419]

Representative Corporations. The representative corporations with respect to which the tax is to be computed under this sec-

[418] Revenue Acts of 1918 and 1921, § 328 (a). This method is much simpler than that prescribed by § 210 of the 1917 Law and reaches approximately the same result.

[419] Revenue Act of 1918, § 335 (a); T. B. M. 30, T. B. 6-19-285. The provisions of § 210, as interpreted by Article 52 of Regulations 41, and § 327 are somewhat different and it is possible that a corporation may be entitled to special assessment under the 1917 Law and not under the 1918 Law, or *vice versa*. In such case it would seem that the tax would be computed as follows: First, as if the entire net income had been earned during the calendar year 1917, the tax being computed thereon under § 210; second, as if the entire net income had been earned during 1918, the tax thereon being computed under § 301. These taxes, one computed by special assessment and the other computed in the ordinary manner, would then be divided into their proper proportions to determine the tax for the fiscal year.

tion are those corporations whose invested capital can be satisfactorily determined in the ordinary manner and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war-profits or excess-profits, and all other relevant facts and circumstances.[420] In each case the Commissioner will determine, as nearly as may be, the group or class of corporations with which the corporation should be compared.[421]

Ratio Between Average Tax and Average Net Income. The ratio between the average tax and the average net income of representative corporations is to be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the secretary.[422]

Payment of 1918 Tax by Corporations Applying for Special Assessment. In cases in which the tax was to be computed without reference to the invested capital, the corporation was required to pay its tax for 1918 in installments without the benefit of special relief, if the tax as so computed was less than 50% of the net income of the taxpayer. But if the tax so computed was 50% or more of the net income, the installments to be paid by the corporation were required to be computed in the first instance upon the basis of a tax equal to 50% of the net income. The actual ratio when ascertained was to be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeded 50% of the net income, any excess of the correct installments over the amounts actually paid became due and payable ten days after notice and demand together with interest at the rate of one-half of 1% per month on such excess from the time the installment was due. If, on the other hand, the amount of the tax was less, upon correct determination, than the amount on which installments had been paid, the law impliedly provided that the amount so paid should either be credited to the installments falling due after final determination, or if all the

[420] Revenue Acts of 1918 and 1921, § 328 (a).

[421] Reg. 45, Art. 911. It seems that the following should be considered in selecting representative corporations: (1) a representative corporation should be fairly representative of all corporations engaged in the same general line of business, as that of the corporation seeking the assessment under this provision of the law; (2) it should operate in the same general vicinity; (3) it should approximate in gross sales, gross earnings, and net earnings; (4) it should approximate as to manner and form of organization, especially financing; and (5) it should have been in business for approximately the same length of time.

[422] Revenue Acts of 1918 and 1921, § 328 (b).

installments had been paid before the tax was finally determined, the amount would be refunded in the usual manner.[423] No interest, however, was payable to the taxpayer on excess amounts paid in the first instance. It was not permissible to file a bond in lieu of cash payments on a 50% basis, pending final determination of tax due.[424] The treasury department required every corporation of the class claiming special assessment *subsequently* to assessment in the ordinary manner to file a claim for abatement on Form 47 for the excess of 50% of its net income. No such abatement claim was required, if special assessment was claimed when the return was filed.[425]

Determination of First Installment of Tax for 1919 in Special Cases. For 1919 and subsequent taxable years, in the case of any corporation other than a foreign corporation, the installments should be determined upon the basis of an excess-profits tax equal to 20% of the net income in excess of $3,000, but not in excess of $20,000, plus 40% of the net income in excess of $20,000. In any other special assessment case other than the case of a foreign corporation, but including a case where the invested capital for the taxable year can not be accurately determined, but where a minimum amount of invested capital, as to which there is no question, can be determined, the installments should in the first instance be determined upon the basis of a war-profits and excess-profits tax computed by using the minimum invested capital, the tax in any such case not to exceed an amount equal to 50% of the net income, and for 1919 and subsequent taxable years not to exceed 20% of the net income in excess of $3,000, but not in excess of $20,000, plus 40% of the net income in excess of $20,000.[426]

Determination of Installments of Tax in the Case of Foreign Corporation. In the case of a foreign corporation the installments of the tax should in the first instance be determined upon the basis of a war-profits and excess-profits tax computed by

[423] Revenue Act of 1918, § 328; Reg. 45, Art. 914. The treasury department also permitted the tax to be computed in the first instance upon the basis of a minimum amount of invested capital as to which there was no question, if this could be determined and was no less than 50% of the net income (Reg. 45, Art. 912, amended by T. D. 3235, T. B. 42-21-1877).

[424] O. D. 94, T. B. 1-19-136.

[425] O. D. 356, T. B. 31-19-655, modifying letter from treasury department dated October 15, 1919; W. T. S. 1919, ¶ 1058. Interest would now seem payable by the government on overpayments (Revenue Act of 1921, § 1324).

[426] Reg. 45, Art. 912, as amended by T. D. 3235, T. B. 42-21-1877.

using its invested capital for the taxable year 1917, such tax for any taxable year not to exceed an amount equal to 50% of the net income, and for 1919 and subsequent taxable years not to exceed 20% of the net income not in excess of $20,000, plus 40% of the net income in excess of $20,000. The invested capital for 1917 should be adjusted for any subsequent changes in its amount due to cash or property paid in or withdrawn or to surplus or undivided profits of prior years retained in the business and properly attributable to its business within the United States. If the tax for 1917 was determined by special assessment the constructive capital which would result in a tax equivalent to the tax so determined should be used. In the case of a foreign corporation which was organized subsequent to the taxable year 1917, or which had no income from sources within the United States during 1917, the installments of the tax should in the first instance be determined upon the basis of a war-profits and excess-profits tax equal to 50% of the net income, except that for 1919 and subsequent taxable years such installments be determined upon the basis of an excess-profits tax equal to 20% of the net income not in excess of $20,000, plus 40% of the net income in excess of $20,000.[427]

No Credit Allowable on Account of Estimate of Excess Payment When Special Relief Undetermined. No claims for credit may be applied under any circumstances against taxes due until a definite determination has been made by way of special relief and the amount of tax due by reference to representative corporations fixed.[428]

Commissioner to Keep Record. The Commissioner is required to keep a record of all cases in which the tax is determined without reference to invested capital containing the name and address of the taxpayer, the business in which engaged, the amount of

[427] Reg. 45, Art. 913, as amended by T. D. 3235, T. B. 42-21-1877. The validity of this ruling seems doubtful in so far as it requires payment of the 1919 excess-profits tax by a foreign corporation upon the maximum basis provided by § 302 or upon the basis of constructive invested capital for 1917. The statute does not provide for the advance payment of any excess-profits tax for 1919 and subsequent years, the 50% provisions being limited to 1918. All foreign corporations are taxable by reference to representative corporations, and it seems doubtful whether they should be required to pay any excess-profits tax for 1919 and subsequent years until assessment has been made by the Commissioner. This ruling will apply under the 1921 Law to domestic corporations taxable under § 262 of that law.

[428] Letter from treasury department dated March 23, 1921; W. T. S. 1921, ¶ 892.

invested capital and net income shown by the return.[429] The Commissioner is required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either house of Congress without regard to the restrictions usually imposed upon him with respect to divulging information contained in income tax returns.[430]

Incorporation of Business of Partnership or Individual. In the case of the organization as a corporation before July 1, 1919,[431] of any business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization might at the option of the individual or partnership be taxed under the Revenue Act of 1918 as the net income of a corporation for income tax, excess-profits and war-profits tax purposes. No taxpayer was entitled to this benefit unless a corporation *de jure* or *de facto* came into existence prior to July 1, 1919.[432] If the individual or partnership chose to adopt this method of taxation the net income and invested capital was computed as if the corporation had been in existence on and after January 1, 1918, and in such cases, (1) amounts distributed on or after January 1, 1918, from the earnings were taxed to the recipients as dividends; (2) all the provisions of the income tax and the war-profits and excess-profits tax sections of the law relating to corporations were applied, so far as practicable, to such trade or business; (3) the trade or business was subject to the capital stock tax imposed by the Revenue Act of 1917 and the Revenue Act of 1918, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value; (4) the undistributed profits or earnings of such taxpayer were not subject to the surtax. The adoption of any other date than January 1, 1918, for such purpose was not permissible. This option to be taxed

[429] The law also requires this record to show the amount of invested capital as determined under subdivision (a) of § 328, but that subdivision does not call for a determination of invested capital and hence this requirement is meaningless.

[430] Revenue Acts of 1918 and 1921, § 328 (c).

[431] The treasury department had no authority to extend the time within which to effect this reorganization (O. D. 223, T. B. 11-19-393).

[432] O. 1023, T. B. 16-20-872. The intention to incorporate, the execution and mailing of the articles of incorporation to the Secretary of State on June 30, 1919, the opening of corporate books as at June 30, 1919, and the manufacturing for one day under the same name used hitherto, in the absence of other proof of user prior to July 1, 1919, does not justify the inference that a corporation *de facto* existed before July 1, 1919.

as a corporation did not apply to any trade or business the net income of which for the taxable year 1918 was less than 20% of its invested capital for such year.[433] In a case in which the partnership net income was more than 20% of its invested capital but the net income of the partnership, taken together with the net income of three corporations, 99% of the stock of which was owned by the partnership, was not over 20% of the invested capital of the partnership and the corporation, but the partnership was not denied the benefit of this provision.[434] Partnership net income, as above contemplated, meant net income after deducting salaries of partners.[435] This provision did not apply retroactively under the 1917 Law.[436]

CONDITIONAL LIBERTY BOND EXEMPTION OF REORGANIZED CORPORATION. If a partnership was an "original subscriber" to Liberty bonds of the fourth series and was reorganized as a corporation prior to July 1, 1919, and elected to be taxed as a corporation from January 1, 1918, it was considered as an "original subscriber" to such Liberty bonds within the meaning of the $45,000 exemption "conditional on original subscription to, and continued holding at the date of the tax return of, two-thirds as many bonds of the Fourth Liberty Loan." The same considerations applied to the $20,000 exemption "conditional upon original subscribing to, and continued holding at the date of the tax return of, one-third as many notes of the Victory Liberty Loan."[437]

Affiliated Corporations.[438] The invested capital of affiliated corporations for the taxable year is the invested capital of the entire group treated as one unit operated under a common control. As a first step in the computation a consolidated balance sheet should be prepared in accordance with standard accounting practices, which will reflect the actual assets and liabilities of the affiliated group. In preparing such a balance sheet all intercompany items, such as intercompany notes and accounts receivable and payable, should be eliminated from the assets and the liabilities, respectively, and proper adjustments should be made in respect of inter-

[433] Revenue Act of 1918, § 330; Reg. 45, Art. 933. This provision is not contained in the Revenue Act of 1921 in regard to the excess-profits tax, but that law contains a similar provision as to the income tax. (Revenue Act of 1921, § 229.)

[434] T. B. R. 27, T. B. 6-19-286.

[435] O. D. 95, T. B. 1-19-1381.

[436] A. R. R. 618, T. B. 39-21-1849.

[437] O. D. 211, T. B. 11-19-373. See also Reg. 45, Art. 79.

[438] Under the Revenue Act of 1921, the filing of consolidated returns is optional with the taxpayer. (See Chapter 10.)

company profits or losses reflected in inventories which at the beginning or end of the taxable year contain merchandise exchanged between the corporations included in the affiliated group at prices above or below cost to the producing or original owner corporation. Such consolidated balance sheet will then show (a) the capital stock of the parent or principal company in the hands of the public; (b) the consolidated surplus belonging to the stockholders of the parent or principal company; and (c) the capital stock, if any, of subsidiary companies not owned by the parent or principal company, together with the surplus, if any, belonging to such minority interest. In computing consolidated invested capital the starting point is furnished by the total of the amounts shown under (a), (b) and (c) above. This total must be increased or diminished by any adjustments required to be made under the provisions relating to invested capital.[439]

INTANGIBLE PROPERTY PAID IN. The following rules govern the inclusion of intangible property in invested capital of affiliated corporations: (1) in respect of corporations whose affiliation is in the nature of parent and subsidiary companies. (a) in the case of intangible property *bona fide* paid in for stock or shares prior to March 3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in or the par value of the stock or shares issued therefor, or in the aggregate 25 per cent. of the par value of the total stock or shares of the consolidation outstanding on March 3, 1917 (determined as indicated in items (a) and (c) of the preceding paragraph), or in the aggregate 25 per cent. of the par value of the total stock or shares shown on the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph, at the beginning of the taxable year, whichever is lowest; and (b) in the case of intangible property *bona fide* paid in for stock or shares on or after March 3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in, or the par value of the stock or shares issued therefor, or in the aggregate 25% of the par value of the total stock or shares shown by the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph outstanding at the beginning of the taxable year, whichever is lowest. (c) When intangible property has been ac-

[439] Reg. 45, Art. 864.

quired in part before and in part after March 3, 1917, the amounts shall be ascertained, respectively, under (a) and (b) above and in the aggregate shall in no case exceed 25% of the par value of the total stock or shares outstanding at the beginning of the taxable year shown in the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph. (2) In respect of corporations affiliated by reason of ownership by the same interests, the limitations with respect to the inclusion of intangible property in invested capital set forth in paragraphs (4) and (5) of subdivision (a) of Section 326 of the statute shall be applied to each corporation separately and the aggregate of the intangible property, so valued, shall be included in invested capital in the consolidated return. In respect of each of the affiliated corporations the aggregate of the amounts ascertained under the provisions of paragraphs (4) and (5) shall in no case exceed 25% of the outstanding capital stock of such corporation at the beginning of the taxable year.[440]

Inadmissible Assets. Where adjustment is required in respect of inadmissible assets, such adjustment must be made on the basis of the consolidated balance sheet with due regard to the adjustments and eliminations set forth in the preceding paragraphs and the general provisions relating to inadmissible assets.[441]

Stock of Subsidiary Acquired for Cash. When all or substantially all of the stock of a subsidiary corporation was acquired for cash, the cash so paid will be the basis to be used in determining the value of the property acquired.[442]

Stock of Subsidiary Acquired for Stock. Where stock of a subsidiary company was acquired with the stock of the parent company, the amount to be included in the consolidated invested capital in respect of the company acquired will be computed in the same manner as if the net tangible assets and the intangible assets had been acquired instead of the stock. If in accordance with such acquisition a paid-in surplus is claimed, such claim must be supported by substantially the same sort of evidence as is required in the case of a claim for paid-in surplus in respect of tangible property paid in by a stockholder to a corporation as a gift or at a value definitely known or accurately

[440] Reg. 45, Art. 865.
[441] Reg. 45, Art. 866.
[442] Reg. 45, Art. 867; T. D. 2901, modifying T. D. 2662.

ascertainable as of the date of payment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor.[443]

INVESTED CAPITAL FOR PREWAR PERIOD. The invested capital of affiliated corporations for the prewar period will be computed on the same basis as the invested capital for the taxable year, except that where any one or more of the corporations included in the consolidation for the taxable year were in existence during the prewar period, but were not then affiliated, then the average consolidated invested capital for the prewar period will be the average invested capital of the corporations which were affiliated in the prewar period plus the aggregate of the average invested capital for each of the several corporations which were not affiliated during the prewar period.[444] The intent of this ruling is to determine affiliation of the prewar years by the affiliation of the taxable years.[445]

PREWAR NET INCOME OF AFFILIATED CORPORATIONS. The consolidated net income of affiliated corporations for the prewar period will be the average consolidated net income for the prewar years of such of the several corporations included in the consolidation for the taxable year as were affiliated during the prewar period plus the aggregate of the average net income for each of the corporations not affiliated during the prewar period which were in existence during all of the prewar period or during at least one full year within the prewar period. The net income of a subsidiary corporation organized during the prewar period by an existing corporation should also be included.[446] The expression "such of the several corporations included in the consolidation for the taxable year as were affiliated during the prewar period" identifies the affiliated corporations of the prewar period and clearly determines that the corporate entities of the consolidated unit for each of the prewar years are those corporate entities affiliated in the taxable year.[447]

NATIONAL BANK STOCKHOLDERS' TRUSTEE ACCOUNTS. It is the custom of national banks to declare dividends which instead of being paid to stockholders, are carried with their consent

[443] Reg. 45, Art. 868; T. D. 2901, modifying T. D. 2662. See also Reg. 45, Art. 837; T. B. R. 49, T. B. 16-19-467.

[444] Reg 45, Art. 869. Full recognition, however, must be given to the provisions of § 330 of the 1918 Law, particularly the last paragraph thereof, and of articles 931-934 of Regulations 45.

[445] A. R. M. 116, T. B. 12-21-1526.

[446] Reg. 45, Art. 802.

[447] A. R. M. 116, T. B. 12-21-1526.

to a stockholders' liability account in the name of a trustee. This account may be used for investment in deals not countenanced by the comptroller of the currency. Although such trustee account is a liability to the individual stockholders and, therefore, from a technical viewpoint, not a part of the invested capital of the bank, even though the bank include income from the reserve in its gross income, the stockholders constitute an "association" in affiliation with the national bank. The amount of the reserve is therefore to be included in consolidated invested capital.[448]

Balance Sheet. Every corporation is required to submit a balance sheet as of the first day of the taxable year and also a balance sheet as of the close of the taxable year. Balance sheets are required to be made in accordance with the books of the taxpayer and changes in respect of any items therein made pursuant to the regulations are to be explained in a separate statement attached to the balance sheet to which it relates.[449]

Returns. Every corporation not expressly exempt from tax and every personal service corporation must make a return regardless of the amount of its net income.[450] Corporations which have no taxable income for the year have been required to fill out only Schedules A and B of Form 1120, which relate to the income tax, and the schedules in support thereof, and are not required to furnish the other information called for by this form.[451] Excess-profits tax returns are now a part of the income tax returns of corporations, and are governed by the same rules as to time, place and manner of filing.

[448] A. R. M. 43, T. B. 17-20-881, overruling O. D. 260, T. B. 16-19-466. Of course, as a practical matter the national bank simply includes such reserve in its own invested capital.

[449] Reg. 41, Art. 54. As to the preparation of consolidated balance sheets, see Chapter 10.

[450] Revenue Act of 1921, § 239; Reg. 45, Art. 621. Under the 1917 law no return of information with respect to prewar invested capital and net income was required if the 7% deduction was accepted, and in the case of individuals or concerns with only a nominal capital. A married woman might make a separate return (Reg. 41, Arts. 75, 76). A husband and wife might file separate excess-profits tax returns for 1917, in which the community income might be divided between them. The invested capital of either the husband or the wife was computed by adding that portion of the invested capital which was his or her separate property to one-half of that portion of the invested capital which was community property. The full amount of the specific exemption authorized by the statute might be claimed by each. (O. D. 881, T. B. 16-21-1581.) See Chapter 3.

[451] Letter from treasury department dated March 24, 1919; W. T. S. 1921, ¶ 851.

Returns in Special Cases. Where a corporation computes its war-profits credit upon the basis of the sum of (a) the specific exemption and (b) an amount equal to 10% of the invested capital for the taxable year, the items on Form 1120, which relate solely to the net income or to the invested capital for the prewar period, need not be filled in.[452] Where a corporation enters on its return a war-profits and excess-profits tax equal to the amount of the maximum tax, the items on Form 1120, which relate solely to the net income for the prewar period and the items which relate to the invested capital for the prewar period and for the taxable year, need not be filled in. Likewise, in the case of a foreign corporation the same items may be disregarded, except that all of schedule I on Form 1120 should be filled in and balance sheets as of the beginning and the end of the taxable year for the entire business of the corporation, both within and without the United States, should be submitted. Corporations which have no taxable income for the year are required to fill out only schedules A and B and the schedules in support thereof on their (separate or consolidated) returns (Form 1120) and are not required to furnish the other information called for by these returns.[453] The Commissioner may at any time specifically call for all or any part of the information which is not so required to be entered on the return. In any case, however, where a claim is made for assessment by reference to representative corporations other than in the case of a foreign corporation, the corporation should fill out all items of the return so far as possible and submit a statement explaining why it is impracticable to fill out the entire return.[454]

Time and Manner of Paying Tax. The war-profits and excess-profits taxes are to be paid at the same times and places, in the same manner, and subject to the same conditions, as provided in the case of payments of income tax; that is, the tax will be paid in installments on the dates specified with reference to the income tax.[455]

452 Telegram from treasury department dated April 10, 1919; W. T. S. 1919, ¶ 1022. Under the 1917 Law it was held that a return of information as to invested capital and net income for the prewar period would not be required if the taxpayer accepted the minimum percentage of 7% as a deduction.

453 Letter from treasury department dated March 24, 1919; W. T. S. 1921, ¶ 851.

454 Reg. 45, Art. 962.

455 Revenue Acts of 1918 and 1921, § 336. As to the time and manner of paying income taxes see Chapter 35.

Penalties. All the provisions of the income tax law not inapplicable, including the provisions relating to penalties, are made applicable to the filing of returns and payment of war-profits and excess-profits taxes.[456]

Administrative Provisions. In general, the administrative provisions applicable to the income tax law are also applicable to the administration of the war-profits and excess-profits tax law.[457]

[456] Revenue Acts of 1918 and 1921, § 336.

[457] Revenue Acts of 1918 and 1921, § 336; Reg. 41, Art. 79.

CHAPTER 44

THE CAPITAL STOCK TAX

This tax is popularly known as the Capital Stock Tax although the statute describes it as "a special excise tax with respect to carrying on or doing business." The present law [1] describes the tax in the same manner as did the 1916 Law [2] and 1918 Law [3] and imposes a tax on and after July 1, 1922, in lieu of the tax imposed by the 1918 Law. The tax is imposed upon every domestic [4] corporation [5] and upon every foreign [6] corporation doing business in the United States. The Revenue Act of 1921 in imposing this tax does not, like the 1916 Law, limit the corporations taxed to those organized "for profit" and apparently applies to every corporation having capital stock whether organized for profit or not, except those exempt from income tax under section 231 of the Revenue Act of 1921 and except such insurance companies as are subject to the tax imposed by sections 243 and 246 of the same law.[7] The tax is imposed "with respect to carrying on or doing business" and is payable in advance by every taxable corporation engaged in business during any part of the preceding year.

Definitions. The word "corporation" is used in this chapter, unless otherwise stated, in the sense defined in the Revenue Act of 1921, and includes a corporation, association, joint-stock company, or insurance company.[8] The phrase "taxable year," as used

1 Revenue Act of 1921, § 1000.

2 Act of September 8, 1916, § 407. It has been held that the 1916 capital stock tax is an excise tax upon a corporation with respect to the carrying on or doing business by the corporation, which is a proper subject of taxation on the part of the government (Washington Water Power Co. v. U. S., decided by the Court of Claims, Feb. 14, 1921; T. D. 3160).

3 Revenue Act of 1918, § 1000.

4 The term "domestic" when applied to a corporation, means "created or organized in the United States," (Revenue Act of 1921, § 2), including only the states, the territories of Alaska and Hawaii, and the District of Columbia. (Reg. 50 Rev., Art. 8.)

5 The term "corporation" includes "associations, joint-stock companies and insurance companies." (Revenue Act of 1921, § 2.)

6 The term "foreign," when applied to a corporation, means created or organized outside the United States. (Revenue Act of 1921, § 2.)

7 Revenue Act of 1921, § 1000. The 1916 Law provided expressly that corporations exempt under the provisions of § 11 of the 1916 income tax law were also exempt for purposes of the capital stock tax.

8 Revenue Act of 1921, § 2; Reg. 50, Art. 11.

in this chapter, means the fiscal year of the government beginning on the first day of July of each calendar year and ending on the last day of June the year following. The phrases "preceding year" and "preceding taxable year" mean the twelve-month period ending immediately prior to the "taxable year" as above defined.

Domestic Corporations. The tax applies to a domestic corporation if (a) it is carrying on or doing business; (b) has capital stock; (c) was engaged in business for some part of the preceding year ending June 30th, and (d) is neither a corporation enumerated as exempt for purpose of income tax, under section 231 of the Revenue Act of 1921, nor an insurance company of a kind subject to the tax imposed by sections 243 and 246 of the same Act. The 1916 Law provided that the corporation should be organized for profit and have a capital stock represented by shares. In this respect the 1921 Law and the 1918 Law are broader and a corporation is liable to tax, whether it is a creature of statute or of contract and whether or not it is organized for profit or has a capital stock represented by shares.[9]

ASSOCIATIONS. It should be noted that the law applies not only to corporations but also to all associations "organized in the United States," and in this respect seems to be broader in its scope than the 1909 Law, which was construed to apply only to corporations, joint-stock companies or associations "organized under the laws of the United States or of any state or territory of the United States or under the Acts of Congress applicable to Alaska or the District of Columbia."[10] Apparently it was the intent of Congress to make the present as well as the former capital stock tax law apply to associations which were held not to be taxable under the 1909 Law, because not organized under some statute. The treasury department has ruled that associations and joint-stock companies include organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to state laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds or, where

[9] Revenue Act of 1921, § 1000.

[10] It was the intention of Congress to embrace within the 1909 Law only such corporations and joint-stock associations as were organized under some statute or derived from that source some quality or benefit not existing at the common law. (Eliot v. Freeman, 220 U. S. 178.) This was a case involving a so-called "Massachusetts Real Estate Trust" which was held not to be taxable under the 1909 Law but which would seem to be taxable under the capital stock tax law.

there is no capital stock, on the basis of the proportionate share of capital which each has or has invested in the business or property of the organization.[11]

ASSOCIATION DISTINGUISHED FROM PARTNERSHIP. An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership.[12] A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership.[13]

ASSOCIATION DISTINGUISHED FROM TRUST. The test of liability in all cases involving trusts of the Massachusetts type is whether the *cestuis que trustent* have by the terms of the trust agreement a voice in the management or control of the trust. Where the trustees are in complete control of the business, the beneficiaries having no control except the right of filling vacancies among the trustees or of consenting to a modification of the terms of the trust or of dissolving the trust, no association exists. If, however, the *cestuis que trustent* have a voice in the control or management of the business of the trust, whether through the right to elect trustees periodically or to remove the trustees or to restrict the trustees as to the management of the trust or otherwise, the trust is an association within the meaning of the statute. Where the trustees hold in their own right a sufficient number of the certificates of beneficial interest to constitute control as between the beneficiaries, the trust will be held to be an association regardless of the powers conferred upon the trustee by the instrument creating the trust.[14]

LIMITED PARTNERSHIP AS PARTNERSHIP. So-called limited partnerships of the type authorized by the statutes of New York and most of the states are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which cannot limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe

[11] Reg. 50 Rev., Art. 3.

[12] Reg. 50 Rev., Art. 3.

[13] Reg. 50 Rev., Art. 6.

[14] Reg. 50 Rev., Art. 7. See Crocker v. Malley, 249 U. S. 223. See Chapter 10 for a full discussion of this subject.

the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which cannot take real estate or sue in the partnership name, are so like common-law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Michigan and Illinois limited partnerships are partnerships. A California special partnership is a partnership.[15]

LIMITED PARTNERSHIP AS CORPORATION. On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other states are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must pay the tax as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. Michigan partnership associations are corporations. The liability of Virginia limited partnerships is determined in each case from a consideration of the certificate of partnership and all pertinent facts relative thereto.[16]

Foreign Corporations. A foreign corporation is taxable if it (a) is "carrying on or doing business in the United States" during the taxable year; (b) was engaged in business in the United States during some part of the preceding year ending June 30th; (c) is not a corporation enumerated in section 231 of the law as exempt from income tax, or an insurance company other than a mutual insurance company and (d) has capital employed in the transaction of its business in the United States.[17] It is to be noted that a foreign corporation is not subject to this tax merely because it receives income from sources within this country. To be taxable, a foreign corporation must be carrying on or doing business in the United States and must have capital employed in the transaction of such business. The chapter on foreign corporations, in the foregoing part of this book, contains decisions and rulings which define what is "doing business" by foreign corporations, and such decisions and rulings have application to this tax. It should be borne in mind, however, that some of the rulings with respect to the taxability of foreign corpora-

[15] Reg. 50 Rev., Art. 5. See Chapter 8 for a full discussion of this subject.
[16] Reg. 50 Rev., Art. 4. See Chapter 8 for a full discussion of this subject.
[17] Revenue Act of 1921, § 1000.

tions under the income tax law have no application to this law, since this tax is imposed only when the foreign corporation is carrying on or doing business in this country and has capital employed in the transaction of such business.[18]

Basis and Rate of Tax. The basis of the capital stock tax differs accordingly as the taxable corporation is domestic or foreign or is an insurance company.

Domestic Corporations. The basis of the tax in the case of all domestic corporations is "the fair average value of its capital stock for the preceding year ending June 30th." The rate of tax is $1 for each full $1,000 of the fair average value of the capital stock in excess of the prescribed deduction. The tax is not upon the par value of the capital stock but upon its fair average value for the preceding year ending June 30, or for the period during which it has been issued if less than a year, of the capital stock outstanding at the date of the incidence of the tax. It is on an entirely different basis from the excess-profits tax which is concerned with invested capital, and not with the present fair value of the capital stock. Stock in the treasury of a corporation is not regarded as outstanding, unless pledged as security for a debt. No deduction is allowed corporations organized in the United States for capital invested outside the United States. If such a corporation is doing any business it is taxed on its entire capital, even though most of it may not be employed in the business.[19] From the total fair average value of the capital stock, the sum of $5,000 is deductible, and the tax is upon each full $1,000 of any balance. Accordingly, corporations the fair value of whose capital stock is not more than $5,000 are not subject to any tax. However, for the purpose of avoiding errors, *every* corporation must file a return, even though the par value or the fair average value of its capital stock does not exceed $5,000.[20]

Fair Average Value of Capital Stock. The law provides that the surplus and undivided profits must be included in estimating the fair average value of the capital stock; that is to say, the capital stock representing the entire ownership of the property of the corporation necessarily includes the surplus and undivided profits. If the fair average value is determined from the book value they are included in the assets; if from sales, they are necessarily taken into consideration in establishing the market price; and if from net income, they are more or less reflected

18 Laurentide Co., Ltd. v. Durey, 231 Fed. 223, and Bryant & May, Ltd. v. Scott, 226 Fed. 875, are cases in point. See page 1155.

19 Reg. 50 Rev., Art. 13.

20 Reg. 50 Rev., Art. 16.

through the earnings.[21] Corporations are now required to make three exhibits: Exhibit A being a condensed balance sheet; Exhibit B, quotations or outside sales prices; and Exhibit C, the annual income for a period of five years. The fair average value of the capital stock for the purpose of determining the amount of the capital stock tax must not be confused with the market value of the shares of stock where it may be necessary to determine such value under other provisions of the revenue laws. The fair average value of the capital stock, the statutory basis of the tax, is not necessarily the book value or the value based on prices realized in current sales of shares of stock or even the value, determined by capitalization of earnings, although it may be more directly dependent upon the last. It should usually be capable of appraisal by officers of the corporation having a special knowledge of the affairs of the corporation and general knowledge of the line of business in which it is engaged. Provision is accordingly made in Exhibit C of Form 707 (Revised) for the tentative determination of the fair value of the capital stock by capitalizing the net earnings of the corporation on a percentage basis fixed by its officers as fairly representing the conditions obtaining in the trade and in the locality. But such fair value, except in the case of insurance companies, must not be set at a sum less than the reconstructed book value shown by Exhibit A, unless the corporation is materially affected by extraordinary conditions which support a lower valuation. In any such case a full explanation must accompany the return. The commissioner will estimate the fair value of the capital stock in cases regarded as involving any understatement or undervaluation.[22]

EXHIBIT A: CONDENSED BALANCE SHEET. This exhibit furnishes a condensed balance sheet as of the closing date of a fiscal year ending on June 30, or on some date between July 1 and June 30, of the preceding year. In one column the value shown on the books of account is required to be stated and in a parallel

[21] Reg. 50 Rev., Art. 15.

[22] Reg. 50 Rev., Art. 14. See Form 707 revised. Prior to July 1, 1918, it was the practice of the treasury department to determine the fair average value of capital stock by means of either (a) the average price at which stock had sold during the preceding year or (b) by estimating the value of the capital stock, taking into consideration the surplus and undivided profits for the preceding fiscal year as well as the nature of the business, its earning capacity and average dividends paid from profits earned during the preceding five years. Only in exceptional cases where the corporation had no net income or only occasional income was the value of the capital stock predicated upon the value of the assets of the corporation.

column adjustment may be made for any overstated or understated values shown on the books of account. In a third column the taxpayer is required to show the difference between the book values and the "fair value." Any material difference is to be explained in such manner as to enable the commissioner to determine if the "fair value" is proper and acceptable. In making adjustments from book values to fair value it is not necessary for the taxpayer to make corresponding adjustments on its books of account. In the event that the taxpayer holds in its treasury any of its own stock or bonds it is required that advice be given as to whether such stock or bonds are pledged or unpledged.

Exhibit B: Quotations or Outside Sales Prices. In this exhibit the taxpayer is required to show prices quoted on a recognized stock exchange or on the New York Curb, or the prices at which outside sales were made if the stock was not listed, for the period of twelve months ending with the close of the taxpayer's last fiscal year. A statement of the number of shares involved and the conditions under which sales were made at other than exchange quotations must accompany the return. Sales to employees or directors for qualifying shares, or sales which were restricted as to resale, or sales at prices otherwise specially influenced, are not considered representative of the fair value of the entire capital stock and should not be reported.

Exhibit C: Annual Income. In this exhibit the taxpayer is required to furnish data for the five fiscal years, ended with the close of the taxpayer's last fiscal year or for the period during which the corporation had been engaged in business, if for a shorter period. The net income reported for the purpose of the income tax is required to be stated in this exhibit. Such net income, however, may be adjusted by deductions or additions in order to reach the actual operating income. Among the principal items which may require adjustment are stated: income taxes not deductible in computing income subject to tax; losses not fully deductible; dividends from other corporations not included in computing income subject to tax; income exempt for purpose of the income tax; expenditures made for additions or betterments, or reserves for such purposes, made against income whether directly or through expenses. The adjusted income will be averaged for the years reported and such average income capitalized at such percentage as the officers of the company making the return from their special familiarity with the business know representative enterprises in their line in their locality must earn in order to maintain their stock at par. In other words, if enterprises engaged in a similar business find it

necessary on the average to earn 8% on their issued capital stock to keep the value of their stock at par, the net income of the corporation making the report is to be capitalized by dividing it by .08.[23]

Foreign Corporations. The tax is at the rate of $1 for each full $1,000 of the capital of a foreign corporation actually employed in the transaction of its business in the United States, and is in all cases to be computed on the basis of the average amount of capital so employed during the preceding year ending June 30. The basis of the tax is accordingly different from that in the case of domestic corporations, which pay a tax measured by the fair average value of their capital stock. No deduction from the total fair average value is allowed in computing the tax.[24] The "capital employed in the transaction of its business in the United States" means that portion of the total capital, surplus and undivided profits of the foreign corporation utilized for the purpose of doing business in the United States.[25] The tax is imposed upon capital employed irrespective of its nature, whether borrowed, paid in, or earned.[26] Any surplus or undivided profits invested in United States bonds or other securities having no connection whatever with the actual business of the corporation transacted in this country is not "capital employed in the transaction of its business in the United States." [27] Bank accounts carried by a foreign corporation in this country are to be considered in computing the amount of capital employed therein if the money is carried on the books of the corporation as capital invested in its business in this country, but not if the money is kept here merely for convenience or investment.[28] A foreign corporation may have income from sources within the United States for the purpose of the income tax and

[23] See Form 707. It has been held that income and excess-profits taxes may be properly deducted from net income, as reported under Exhibit C, even though not actually paid, if the amount has been definitely determined and explanations are submitted for consideration in the final audit. (Telegram from treasury department dated July 10, 1919; W. T. S., ¶ 3126.) In capitalizing average net income under Exhibit C, no attention must be paid to changes in amount of issued stock during income producing period. (Telegram from treasury department dated July 27, 1920; W. T. S. 1921, ¶ 3101.)

[24] Reg. 50 Rev., Art. 20.

[25] Reg. 50 Rev., Art. 18.

[26] Telegram from treasury department dated October 30, 1919; W. T. S. 1921, ¶ 3045.

[27] T. D. 2467.

[28] Letter from treasury department dated February 10, 1917; W. T. S. 1918, ¶ 3131.

yet not have capital employed in the transaction of business here for the purpose of the capital stock tax. A foreign corporation actually itself not doing business in the United States is not subject to the tax, and accordingly the investment of a part of its funds in United States stocks and securities would not constitute capital employed in its business in the United States. But if a corporation does business here, then, although the mere investment of funds in United States securities is not such a taxable employment of capital, such investment will constitute capital employed in the transaction of business in the United States if made in a subsidiary corporation which the foreign corporation uses as an instrumentality for the successful conduct of its own business here. Thus, funds of a foreign corporation invested in the purchase of facilities, though apparently independent, for the purpose of its business here, or the purchase of stock and securities of a subsidiary corporation for the same purpose, will constitute capital employed in the transaction of business in the United States. A foreign corporation may not escape taxation by organizing or purchasing stock of another corporation to own the facilities which the taxpayer needs in its business. A foreign corporation may employ capital in the transaction of its business in the United States in various ways, as for example, in the investment of funds in property in the United States used in its business, in stocks, and securities of subsidiary corporations as explained above, in bills and accounts receivable representing business done in the United States, in merchandise kept here for sale, in materials manufactured here, and in deposits in United States banks maintained for use in business here, and not merely for convenience or investment. In general, approximately such proportion of the entire capital of a foreign corporation will probably be employed in the transaction of its business in the United States as the gross amount of its business in the United States bears to its total gross business, but this is not always true, for a corporation may conceivably transact a greater or less volume of business in one country than in another on the same amount of capital.[29] The basis of the tax is the average amount of capital employed in the transaction of business in the United States during the preceding fiscal year.

[29] Reg. 50 Rev., Art 18 and 19. In the case of a foreign corporation it is often just as difficult to estimate the "gross amount of business in the United States" for the purpose of calculating the proportion of its entire capital employed here as it will be to determine in the first instance the proportion of capital employed in the transaction of business in the United States.

It will usually be sufficient to determine the amount of capital so employed at the beginning of such year and the amounts so employed at the end of such year and to divide the sum of such amounts by two. However, where there have been material changes in the amount of capital the average amount should be determined with due regard to the times at which such changes occurred. The foreign corporation may, if desired, compute the average amount of capital employed on a monthly basis.[30]

Insurance Companies. The present law provides that the capital stock tax shall not apply to "any insurance company subject to the tax imposed by section 243 or 246." The former section imposes a tax "upon the net income of every life insurance company" and the latter section imposes a tax "upon the net income of every insurance company (other than a life or mutual insurance company)." The result appears to be that all insurance companies are exempt from capital stock tax under the Revenue Act of 1921, except mutual insurance companies.[31] The following paragraphs describe the taxation of the capital stock of insurance companies under the Revenue Act of 1918.

[30] Reg. 50 Rev., Art. 21. One of the rules prescribed by the treasury department for determining capital employed in the transaction of business of a foreign corporation in the United States for the year ending June 30, 1917, was as follows: (1) Take the entire invested capital of the corporation, as shown by its last return within the year ending June 30 for the purpose of the excess-profits tax imposed by the Act of October 3, 1917, or if no such excess-profits tax return has been made by the corporation, compute the invested capital for its fiscal year ending within the year ending June 30 in accordance with the excess-profits tax regulations. (2) Find the proportion, expressed in percentage, which the net income from sources within the United States bears to the entire net income for the fiscal year ending within the year ending June 30, such income being ascertained upon the same basis and in the same manner as for the income and excess-profits taxes. (3) Apply the percentage found in (2) to the average invested capital ascertained in (1), the result being the amount of capital invested in the United States. (Reg. 38 Rev., Art. 20.)

[31] Revenue Act of 1921, § 1000 (b).

The nature of mutual insurance is indicated by the following language of Lord Herschel, quoted in Mutual Insurance Co. v. Herold, 198 Fed. 199, 209.

"In the case before us, certain persons have associated themselves together for the purpose of mutual insurance; that is to say, they contribute annually to a common fund out of which payments are to be made in the event of death to the representatives of persons thus associated together. Those persons are alone the owners of the common fund, and they alone are entitled to the management of it."

The following statements are also pertinent:

Stock Insurance Companies Under 1918 Law. Insurance companies having a capital stock as distinguished from mutual insurance companies are taxable upon the same basis as other corporations, whether domestic or foreign, except that in computing the tax such reserve funds, which include deposits, as they are required by law or contract to maintain or hold for the protection of, or payment to, or apportionment among, policyholders, are not to be included. In the case of such companies the tax will be computed by deducting from the total book value of the assets the amount of the actual liabilities and legal reserves, unless the facts in the case indicate that the book value of the assets is substantially different from their fair market value, in which case it is permissible to make proper adjustment. In a case requiring such adjustment the market value of the shares of stock as shown by Exhibit B or the net earnings of the company as shown by Exhibit C in Form 707 (Revised) should be considered, as well as the fair value of the assets.[32]

Mutual Insurance Companies Under 1918 Law. The tax applies to domestic and foreign mutual insurance companies. A mutual protective association organized under a statute, whose

"The theory of a mutual insurance company, is that the premium paid by each member for the insurance of its property constitutes a common fund, devoted to the payment of any losses that may occur." (Union Insurance Co. v. Hoge, 21 How. 35, 64.)

"The principle of mutuality exists when the persons constituting the company contribute through cash or assessable premium notes, or both, as the plan of transacting business may provide, to a common fund out of which each is entitled to indemnity in the case of loss * * *. Persons so associated are said to be members of the company. They have, or may have, a voice in the management of its affairs, and are practically both insurers and insured." (Spruance ex rel. v. Farmers & Merchants Insurance Company, 10 Pac. 285, 287. See also State v. Willett, 171 Ind. 296, 86 N. E. 68, 70.)

"It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholders * * *. Mutual fire, mutual marine, and mutual life insurance companies are analogous in that each performs the service called insurance wholly for the benefit of the policyholders and not, like stock insurance companies, in part for the benefit of persons who as stockholders have provided working capital on which they expect to receive dividends representing profits from their investment. In other words, these mutual companies are alike in that they are co-operative enterprises." (Penn. Mutual Life Insurance Co. v. Lederer, 252 U. S. 523.) See also L. O. 1063, T. B. 19-21-1626. Of course, certain kinds of mutual insurance companies are exempt under the provisions of § 231 (10). See §§ 1000 (b) and 231 (10) of the Revenue Act of 1921.

32 Reg. 50 Rev., Art. 22.

only source of revenue is the assessments paid by its members and whose net income for each year is paid into a reserve fund, constituting the sole resource of the company, aside from current assessments for the payment of losses, is an insurance company within the meaning of the statute. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer.[33] An organization doing business on the "inter-indemnity" or "reciprocal insurance" plan through an attorney-in-fact subject to direction of an advisory board of policyholders, which requires advance deposits to cover the cost of the insurance and maintains investments or deposits from which substantial income is derived is a mutual insurance company subject to capital stock tax and payment of tax on issuance of insurance policies.[34]

Domestic Mutual Insurance Companies. Under the 1918 law the tax is $1 for each full $1,000 of the excess over $5,000 of the sum of (a) the surplus or contingent reserves maintained for the general use of the business and (b) any reserves the net additions to which are included in net income for the purpose of the income tax, in both cases figured as of the close of the last taxable year of the company. The net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with state or territorial officers pursuant to law as additions to guarantee or reserve funds and, in the case of corporations issuing policies covering life, health and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, including such portion of the net addition not required by law made within the taxable year to reserve funds as is needed for the protection of the holders of such combination policies, is not included in net income for the purpose of the income tax.[35]

Foreign Mutual Insurance Companies. Under the 1918 law the tax is $1 for each full $1,000 of the same proportion of

[33] Reg. 50 Rev., Art. 23. Revenue Act of 1918, § 1000 (c). Under the 1916 capital stock tax law it was held that mutual insurance companies and other associations not having capital stock represented by shares would be held exempt from the tax in the absence of a basis for the computation thereof under that law. (T. D. 2364.)

[34] L. O. 1063, T. B. 19-21-1626.

[35] Reg. 50 Rev., Art. 24.

the sum of (a) and (b) in the last paragraph which the reserve fund upon business transacted within the United States is of the total reserve upon all business transacted, calculated as of the close of the last taxable year of the company.[36]

Corporations Engaged in Business During Preceding Year and During Taxable Year. The tax being payable in advance does not apply to any corporation which was not engaged in business during any part of the fiscal year preceding the year for which the tax is due, but if it was in business even one day of the preceding year and one day of the taxable year it is subject to the tax. There is no relation between the amount of the tax payable and the length of time the corporation was in business. A corporation engaged in business during a part of the preceding year, but not engaged in business at the beginning of the taxable year, is not required to make any return if it is dissolved or in process of dissolution, but if it is only temporarily inactive and subsequently during the year re-engages in business it should file a return in the month in which it recommences business and pay the tax due from the first of such month to the end of the taxable year. A corporation organized and beginning corporate activities on or after July 1 is not subject to tax for the remainder of the taxable period in which the company was organized, unless, as of *July* 1, it takes over the business of an organization which was subject to capital stock tax, in which event the new corporation is required to file a return and pay the tax. In the case of foreign corporations "engaged in business," means the transaction of any business within the United States.[37]

Inactive Corporations. A domestic corporation is not taxable unless it carries on or does business in the taxable year. But if such corporation has paid the special excise tax at the beginning of the taxable year and ceases to do business before the close of that year, no refund is allowed for that portion of the year in which the corporation does no business.[38] The same rule applies in respect of foreign corporations, except that the business in question must be engaged in or carried on or done in the United States.

Carrying On or Doing Business. The basis of the tax in the case of a domestic corporation is "carrying on or doing business" in the capacity of a corporation, association, or insurance company. The words "carrying on or doing business" must be given

[36] Reg. 50 Rev., Art. 35.
[37] Reg. 50 Rev., Art. 26.
[38] Reg. 50 Rev., Art. 1.

their ordinary and natural signification. "Business" is a very comprehensive term and embraces whatever occupies the time, attention or labor of men for the purpose of livelihood or profit. In other words, business necessarily involves the idea of gain.

The true basis of distinction is, in the first instance, between—

(a) A corporation organized for the purpose of doing business as above defined, and

(b) A corporation organized for the sole purpose of owning and holding property and distributing its avails;

and, in the second instance, between—

(c) A corporation of Class (a) which is continuing the body and substance of the business for which it was organized or is still active and maintaining its organization for the purpose of continued efforts in the pursuit of profit or gain, and

(d) A corporation which, although included in Class (a), has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing its avails, and doing only the acts necessary to the maintenance of its corporate existence and the private management of its purely internal affairs.

The distinction in each case must depend upon the peculiar facts in the case. Corporations of Class (a) will be presumed to be subject to the tax unless they submit proof, satisfactory to the commissioner, that they are not actually carrying on or doing business. If a corporation claim exemption on the ground that it belongs to Class (b), it will be required to file an excerpt from its charter setting forth its corporate powers together with a full and comprehensive statement showing the nature of the activities in which it is and has been actually engaged. If it claim exemption on the ground that it belongs to Class (d), it will be required to furnish a copy of any amendment of its charter, resolution of its board of directors, or other evidence, satisfactory to the commissioner, showing that it has reduced its activities to the mere ownership of property, receipt of its avails, and the doing of only what is necessary to the maintenance of its corporate existence.[39]

[39] Reg. 50 Rev., Art. 10. Von Baumbach v. Sargent Land Co., 242 U. S. 503. It was held in Associated Pipe Line Co. v. U. S., 258 Fed. 800, that the amount of business done is immaterial. On the other hand, it has been held that the existence of occasional and isolated transactions does not constitute the doing of business (Lewellyn v. Pittsburg Co., 222 Fed. 177; Penn. Collieries v. McKeever, 183 N. Y. 98).

The meaning of the term "engaged in business" in relation to domestic corporations was defined by a number of decisions under the 1909 law, with particular reference to cases where corporations had ceased to do business. Thus, it was held that where a corporation, originally organized for the purpose of owning and renting an office building, leased its property for 130 years, its sole authority under its charter thereafter being to hold the title subject to the lease and to receive and distribute the rentals which might accrue under the terms of the lease, or the proceeds of any sale of the land should it be sold, it was not engaged in business within the meaning of that law.[40] The actual terms of the lease will assist in deciding a question of this kind. In another case, it was held that a railroad corporation which had leased its property for a term of years, and parted with its control and management, maintaining, however, its corporate organization, collecting rentals from the lessee, and distributing the same among its stockholders, was not engaged in business. The mere receipt of interest and dividends from invested funds, bank balances, and the like, and the distribution among the stockholders of a corporation, amount to no more than receiving the ordinary fruits that arise from the ownership of property and do not constitute doing business. The mere ownership of undeveloped coal or timber lands, without operating them, does not constitute doing business.[41] Where, however, a corporation was organized to build and lease property, the fact that it had leased all of its property and did nothing except collect and distribute the rents, did not exempt it from the tax, since such collection and distribution of rents from the leased property was the business for which it was organized.[42] A company whose activities include something more than the mere holding of property and the distribution of the receipts thereof is "doing and engaging in business."[43] These and other deci-

[40] Zonne v. Minneapolis Syndicate, 220 U. S. 187.

[41] McCoach v. Mine Hill & Schuylkill Haven R. R. Co., 228 U. S. 295; West End Street Ry. Co. v. Malley, 246 Fed. 625. Reg. 50, Art. 19.

[42] Rio Grande Junction Ry. Co. v. U. S., 51 Ct. Cls. 274. It will not be found easy to reconcile this case with the case of U. S. v. Emery, 237 U. S. 28, where a corporation was organized for the very purpose of owning and leasing a specific piece of property and of receiving and distributing the rents therefrom, yet was held not to be doing business.

[43] Von Baumbach v. Sargent Land Co., 242 U. S. 503. The activities referred to in this case included selling and leasing property, selling stumpage, making explorations, and employing another company to see that mining operations were properly carried on and that the lessees lived up to their engagements.

sions[44] will be followed by the treasury department where the decisions are by the United States Supreme Court or, if by the lower courts, have been acquiesced in by the department.

The treasury department has held the following corporations to be doing business: (1) Corporations organized for the purpose of and actually engaged in such activities as buying, selling, or dealing in mineral or timber land, or other real estate; leasing property, collecting rents, managing office buildings, making investments of profits; leasing lands and collecting royalties, managing wharves, dividing profits; and in some cases investing the surplus; (2) A corporation organized for the purpose of, and actually engaged in, buying mineral or timber land or other real estate and holding it with a view to future sale at an advance; (3) A corporation organized for the purpose of owning and leasing real estate which has leased all of the property under its control under the terms of its lease, unless its activities have been reduced to the mere receipt and distribution of the avails of the leases at the actual cost of so doing. (If it is still maintaining its organization for the purpose of continued effort in the pursuit of profit and gain it is doing business.) (4) A corporation owning or managing real estate which leases all of its property but under the terms of the lease is required to maintain or keep the property in repair; (5) A corporation engaged in mining or in developing and speculating in mineral lands; (6) A corporation engaged in buying and selling securities or other property even though for a period it makes no purchases or sales because of unfavorable market conditions; (7) A corporation formed to take over miscellaneous stocks, bonds or other property (as of an estate), to negotiate sales of various items from time to time as opportunity and judgment dictate, and to distribute the profits from time to time as liquidation is effected,

[44] Other cases arising under the 1909 Law are: Anderson v. Morris & Essex R. R. Co., 216 Fed. 83; Cambria Steel Co. v. McCoach, 225 Fed. 278; Jasper, etc., Ry. Co. v. Walker, 238 Fed. 533; Lewellyn v. Pittsburg, etc. R. R. Co., 222 Fed. 177; McCoach v. Continental Passenger Ry. Co., 233 Fed. 976; Miller v. Snake River Valley R. R. Co., 223 Fed. 946; New York Central v. Gill, 219 Fed. 184; New York Mail, etc., Co. v. Anderson, 234 Fed. 590; Philadelphia, etc., R. R. Co. v. Lederer, 242 Fed. 492; Philadelphia Traction Co. v. McCoach, 224 Fed. 800; Public Service Electric Co. v. Herold 229 Fed. 902; Traction Companies v. Collector of Internal Rev., 223 Fed. 984; Wilkes-Barre, etc., Traction Co. v. Davis, 214 Fed. 511; Boston Terminal Co. v. Gill, 246 Fed. 664; Old Colony R. Co. v. Gill, 257 Fed. 220; Associated Pipe Line Co. v. U. S., 258 Fed. 800; State Line & S. R. Co. v. Davis, 228 Fed. 246; Waterbury Co. v. Walsh, 228 Fed. 54; West Ry. Co. v. Malley, 246 Fed. 625; Chemung Iron Co. v. Lynch, 269 Fed. 368; Flint v. Stone-Tracy Co., 220 U. S. 107; U. S. v. Nipissing Mines Co., 206 Fed. 431.

while so engaged; (8) A parent corporation which finances or manages the operations of its subsidiaries; (9) A so-called holding company which, under its charter, is authorized to and does, in addition to receiving and distributing the avails of the property or securities, held by it, finance the operations of its subsidiaries; (10) A corporation organized for the purpose of taking over and holding securities, timber land, coal lands, or other real estate, if it makes investments or reinvestments of its surplus income or funds in excess of an amount necessary to maintain its original investments.[45]

Not "Doing Business." Holding companies as distinguished from parent corporations, and corporations all of whose property and business is operated by, or is in the hands of, a receiver or the alien property custodian, are not doing business. A holding company is defined as one whose corporate powers are limited to the mere owning and holding of property and distribution of its avails, or one which, although incorporated for the purpose of doing business as defined in the preceding paragraph, has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing its avails, and doing only such acts as are necessary to the maintenance of its corporate existence and the private management of its purely internal affairs. A holding company, as above defined, will not be considered to be doing business by reason of the reinvestment of its surplus income or funds to the extent only of maintaining its original investments.[46]

Doing Business by Foreign Corporations. A foreign corporation is "carrying on or doing business" in the United States if it maintains agents or an office or warehouse here, or in the case of an insurance company writes insurance policies here or in any other way enters the United States for the purpose of its business. The purchase of supplies in the United States in the furtherance of continued efforts in the pursuit of profit or gain is carrying on or doing business in the United States.[47] The mean-

[45] Reg. 50 Rev., Art. 11. The question of "doing business" by a railroad corporation under federal control is treated in Reg. 50 Rev., Arts. 20 and 21. See also T. D. 3156; also 1920 Edition, p. 730.

[46] Reg. 50 Rev., Art. 12. See also Reg. 50 Rev., Art. 19. Reg. 38 Rev., Art. 6. These regulations reversed the earlier holding of the treasury department and were probably based upon the case of Butterick Co. v. U. S., 240 Fed. 539.

[47] Reg. 50 Rev., Art. 17.

ing of the term in relation to foreign corporations has been referred to in a previous paragraph.[48]

Exempt Corporations. The special excise tax is expressly made inapplicable to any corporation exempted for income tax purposes.[49] As foreign corporations falling within the classes enumerated as exempt in the income tax law (except in the case of building and loan associations and co-operative banks) are exempt for income tax purposes,[50] they are also exempt from this tax, if falling within such enumerated classes. All insurance companies, except mutual companies, are exempt under the present law.[51] However, mutual hail, cyclone or fire insurance companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues and fees collected from members for the sole purpose of meeting expenses, are also exempt.[52] But if a mutual insurance company derives substantial income from investments of savings on premiums, it is not exempt under the provisions of section 231 (10) because in such a case its income does not consist "*solely* of assessments, dues and fees."[53] A corporation paying this tax is not on that account exempt from any occupational tax.[54]

Tax Due. This tax is an excise tax on the privilege of doing business, similar to occupational taxes imposed on individuals. Being a privilege or occupational tax, it is payable annually in advance for each year beginning July 1. Special taxes, of which this is one, become due on the first day of July in each year, or on commencing any trade or business on which such tax is imposed.[55] The tax is payable to the collector at any time after such due date, but penalties for non-payment do not attach until ten days after notice and demand therefor have been served by the collector upon the taxpayer.[56]

Returns. Returns are required to be filed on or before the 31st of July of each year with the collector of the district in which the principal place of business of the corporation is lo-

48 See pp. 1142 and 1147.

49 Revenue Act of 1912, § 1000 (b).

50 Letter from treasury department dated December 6, 1916; I. T. S. 1918, ¶ 1182; Reg. 38 Rev., Art. 12. This decision was of course under the 1916 Law, but there seems no reason for reaching a different conclusion under this law.

51 Revenue Act of 1921, § 1000 (b). See pp. 1148 and 1150.

52 Revenue Act of 1921, § 1000 (b) and 231 (10).

53 L. O. 1063, 19-21-1626.

54 Reg. 50 Rev., Art. 41.

55 Reg. 50 Rev., Art. 1.

56 See T. D. 2423 and Chapter 35 for ruling as to notice and demand.

cated.[57] Forms will be sent to taxable corporations known to collectors, but failure to receive a blank form will not relieve a corporation from the penalties prescribed by law for failure to make the return within the time required. All the information called for in the forms must be given in every case where it is procurable.[58]

IN WHAT CASES REQUIRED. A return is required of every domestic corporation engaged in business, regardless of the par value, or the actual value, of its capital stock, unless such corporation was not engaged in business during the preceding taxable year, in which case it proceeds as indicated in a paragraph below.[59]

EXTENSION OF TIME. If failure to file a return is due to sickness or absence, the collector may allow such further time, not exceeding 30 days, for making and filing the return as he deems proper.[60] There is no authority in the law for granting an extension *for any reason* beyond 30 days from July 31 and a corporation with a fiscal year ending on June 30 will be obliged to file its capital stock return on or before August 30, even though it has not yet filed its income tax return. Such corporations should complete their capital stock returns insofar as practicable and file with them a statement that unavailable data will be furnished in a supplemental report as soon as possible. This procedure will obviate any assertion of penalties and any question as to what constitutes a reasonable cause.[61]

RETURNS TO BE PUBLIC RECORDS. Returns filed pursuant to the special excise tax law constitute public records, and are open to inspection in all respects the same as income tax returns.[62]

TENTATIVE RETURNS. If for reasons, other than absence or sickness, beyond the control of the officers making the return,

[57] Reg. 50 Rev., Art. 33; See R. S. 3173 as re-enacted by § 1311 of the Revenue Act of 1921.

[58] Reg. 50 Rev., Art. 31.

[59] Reg. 50, Art. 23; Reg. 38 Rev., Art. 18. If a corporation claims exemption on the ground that it is not doing business, it should complete the first five lines of Form 707, attaching comprehensive explanation of such grounds. (Telegram from treasury department dated July 25, 1919; W. T. S. 1919, ¶ 3127.)

[60] Reg. 50 Rev., Art. 33. It was decided under the 1916 capital stock tax law that the tax was not illegal because assessed and collected in advance (Washington Water Power Co. v. U. S., decided by Court of Claims, Feb. 14, 1921, T. D. 3160).

[61] Letter from treasury department dated July 11, 1919; W. T. S. 1919, ¶¶ 3121-3125.

[62] Revenue Act of 1921, § 1000 (c); Reg. 50 Rev., Art. 30; See Chapter 34.

it becomes impossible to file a completed return within the time prescribed by law, a tentative return may be filed, thus avoiding penalty for failure to file within the prescribed time. The filing of a tentative return will avoid the penalty for delinquent filing, but does not authorize the withholding of the tax. The regulations do not permit the filing of a tentative return to stay indefinitely the filing of a completed return and the collection of the tax due; therefore, a tentative return clearly marked "Tentative return" should be prepared in as complete a manner as possible, including, among other information, a basis for the computation of the tax—that is, an estimate by the officers of the corporation of the approximate fair value of the capital stock in order that an initial assessment may be made. When the completed return is filed, it should be clearly marked "Completed return," showing that a tentative return was filed. Such action will prevent duplicate assessments and ordinary penalties. In every case a statement should be attached to the tentative return, indicating the approximate date the completed return may be expected. Upon receipt of the completed return any adjustment necessary in the assessment of the correct tax due will be made.[63]

Return by Corporation Claiming Exemption. Where the officers of a corporation are of the opinion that it is exempt because of being an exempt organization under the income tax law, or on account of not being engaged in business, Form 707 (Revised) should be filled out and filed with the collector, together with a comprehensive statement of the reasons for claiming exemption. In such case the fair value should be reported on page 1 of the form, but the tax not computed, notation "Exemption claimed" being made instead. If exemption has been allowed for the preceding taxable year and there has been no change in the status or conditions of the company then the first 14 lines of Form 707 (Revised) should be completed and a statement attached to the effect that exemption is claimed for the same reasons as for the previous year and that the same status and conditions of the company exist for the taxable period in question. In this way the records of the collectors' offices will be complete and corporations will avoid requests for the filing of returns and unnecessary correspondence. The determination of liability rests in the first instance with the commissioner and without complete information it is impossible to make a decision.[64]

[63] Reg. 50 Rev., Arts. 33 and 34.
[64] Reg. 50 Rev., Art. 28.

Return by Affiliated Corporation. Although under the income tax law consolidated returns may be filed in the case of affiliated corporations *for the purpose of capital stock tax each corporation must render a separate return in complete form.* So-called subsidiary corporations, all or a part of the stock of which is owned by another corporation, must render separate returns, the same as every other corporation. No deductions from the assets are permitted on account of inter-company balances, and the shareholdings must be reported in the "Fair value" column at their actual worth at the time of making the return. No deduction is allowed in the return of one corporation for the tax paid by another. If the fair value is determined by any method other than by Exhibits A, B and C, the following requirements must be complied with: (a) The parent company must submit with its return a list of all subsidiaries and the districts in which the returns were filed; (b) the return of the subsidiary company must show the name of the parent company and the district in which the return was filed; (c) the method of determining the fair value, if other than by Exhibits A, B and C, must be fully explained; (d) a copy of any agreement existing between parent company and subsidiary must be furnished, or a statement made that none exists; and (e) a combined balance sheet and a combined net income statement must be submitted for consideration in connection with any estimate of fair value made on behalf of the reporting corporation.[65]

Returns of Affiliated Corporations Based upon Consolidated Report. In many cases, as for instance, in the case of selling agencies separate corporations are formed in order properly to handle certain business under various state laws and in reality are branches or departments of the parent corporation. The business is controlled by the parent corporation and the result of operations is a matter of bookkeeping. The capital stock tax being imposed upon the fair value of the capital stock of corporations, it makes little difference by what method such fair value is determined. Therefore, if the fair value of the capital stock of affiliated corporations cannot be determined independently and such corporations are best able to determine the fair value of the respective companies through a consolidated report, such privilege is permitted by the department, but it seems preferable to leave this to the corporations interested subject to approval by the commissioner rather than attempt to outline a spe-

65 Reg. 50 Rev., Art. 35.

cific method that would apply to all. Under all circumstances, however, separate *returns* are required of all affiliated corporations, regardless of the basis used in arriving at fair value.[66]

Returns by Foreign Corporations. A return is required of every foreign corporation engaged in business in the United States, irrespective of the amount of capital employed in this country in the transaction of its business. The capital actually employed in the transaction of the business of the foreign corporation in the United States and the tax payable thereon should be calculated in accordance with the instructions on the form (Form 708).[67]

Payment of the Tax. All assessments are made by the commissioner. The collector, within ten days after receiving any list of taxes from the commissioner, gives notice to each corporation liable to pay any tax stated therein, to be left at its place of business or to be sent by mail, stating the amount of such tax and demanding payment thereof. All taxes are payable directly to the collector who has no authority to extend time for the payment of the tax. The collector may accept payment of the tax when the return is filed as an "advance collection," subject to any adjustment later found necessary, but no corporation is required to pay the tax until within ten days after notice and demand. The tax due from a corporation is legally collectible from the stockholder or others who have received its assets on liquidation.[68]

Penalties. Any corporation carrying on business without having paid the tax therein provided is subject to a penalty of not more than $1,000, besides being liable for the payment of such tax.[69]

Administration of the Law. All administrative or special provisions of the internal revenue laws including the laws relating to the assessment of taxes, so far as applicable, are extended to and made a part of the Revenue Act of 1921 (including the Special

[66] Letter from treasury department dated June 2, 1919; W. T. S. 1919, ¶ 3120; letter from treasury department dated November 11, 1919; W. T. S. 1919, ¶ 3129.

[67] Reg. 50 Rev., Art. 32.

[68] Reg. 50 Rev., Art. 36. For the provisions relating to payment by uncertified checks and the procedure with respect to dishonored checks, see Chapter 35 and Reg. 50 Rev., Arts. 39 and 40.

[69] Revenue Act of 1921, § 1004; Reg. 50 Rev., Art. 41. As to penalties for failure to make returns, for making false returns, and for delay in paying the tax, see § 1302 of the Revenue Act of 1921, and R. S. 3176 (as re-enacted by § 1311 of the Revenue Act of 1921), a discussion of which sections will be found in Chapter 36. See also Reg. 50 Rev., Arts. 42 and 43.

Excise Tax) and every corporation liable to the tax considered in this chapter is required to keep such records and render, under oath, such statements and returns, and comply with such regulations as the commissioner may prescribe.[70]

[70] Revenue Act of 1921, § 1300. Title XIII of the Revenue Act of 1921 contains general administrative provisions, most of which apply to the capital stock tax as well as to the income and other taxes. This is true, for example, of § 1303 giving the commissioner general power to make necessary regulations, §§ 1308 and 1309 dealing with examination of books and witnesses; § 1310 respecting jurisdiction of courts; § 1315 dealing with refunds, etc. Inasmuch as reference to these sections will be found in other parts of this volume, no special discussion of them is included at this place.

CHAPTER 45

THE STAMP TAX

The present stamp tax is imposed under Title XI of the Revenue Act of 1921, the date of incidence of which, that is, the first day on which the tax applied, was January 1, 1922. This title is practically a re-enactment of Title XI of the Revenue Act of 1918 (referred to in this chapter as the "former" or 1918 Law), except that the tax no longer applies to bonds of indemnity and surety, or to parcel-post packages. Various other changes of less importance will be noted in the paragraphs of this chapter to which they are applicable. The taxes imposed by the Revenue Act of 1921 are, in the case of any article upon which a corresponding stamp tax was hitherto imposed by law, in lieu of such tax.[1] Title XI of the Revenue Act of 1918 became effective on April 1, 1919,[2] and was to some extent a re-enactment of the War Stamp Tax Act of 1917 (Title VIII of the Act of October 3, 1917, referred to in this chapter as the 1917 Law), but the two acts differ in certain respects.[3] The Revenue Act of 1918, like the 1917 Law, did not contain Schedule B of the Act of October 22, 1914 (referred to in this chapter as the 1914 Law), which provided for a tax on perfumery, cosmetics and similar articles and chewing-gum or substitutes therefor. The 1914 Law was preceded by the Act of June 13, 1898 (referred to in this chapter as the 1898 Law).[4]

General Scope of Present Law. The present law taxes the following subjects: Bonds of indebtedness, the original issue of certificates of stock or of profits or interest in property or accumulations of corporations, the sale or transfer of shares or certificates of stock or of profits or of interest in property or accumulations in corporations, sales of produce on exchange, drafts or checks (payable otherwise than at sight or on demand), promissory notes, conveyances, entries of goods at custom house, entry for withdrawal of goods from custom bonded warehouse,

[1] Revenue Act of 1921, § 1100.

[2] Revenue Act of 1918, § 1100.

[3] The 1917 Law went into effect on December 1, 1917, except as to the tax on playing cards which became effective on October 4, 1917.

[4] Other Stamp Tax Acts will likewise be referred to in this chapter for the sake of brevity by the years of their respective enactments. For an historical discussion of stamp tax legislation in the United States, see Edwards v. Wabash Ry. Co., 264 Fed. 610.

passage tickets on vessels to foreign countries (except Canada or Mexico), proxies, powers of attorney, playing cards and certain insurance policies.[5] The several subjects appear below in alphabetical order, together with the rates applicable to each and rulings with respect to each. This list includes a number of instruments not taxable under the present law to which reference is made for the convenience of the reader who may be searching for positive assurance that a particular instrument need not be stamped.

General Exemptions. The following are not subject to stamp tax: (a) bonds, notes, or other instruments issued by the United States, or by any foreign government, or by any State, Territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power; (b) bonds of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-savings certificate, warrant or check, issued by the United States;[6] (c) stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, or by mutual ditch or irrigation companies.[7] Special exemptions applying to various instruments specified in the law are referred to in the paragraphs dealing with such instruments.

Stamps. Stamps are kept on sale by collectors, and stamp deputy collectors of internal revenue and postmasters in the United States,[8] and are also on sale at United States depositaries.[9] Stamps issued under the 1914 and 1917 Laws were permitted to be used in paying stamp taxes pursuant to the Revenue Act of 1918.[10] Documentary Stamps only must be used upon papers, documents and instruments subject to tax except as provided in the regulations relating to stamp taxes on issue and transfers of stock and sales of products for future delivery.[11] Ordinary post-

[5] Revenue Act of 1921, Title XI, Schedule A.

[6] Revenue Act of 1921, § 1101. Since bonds of indemnity and surety are no longer subject to stamp tax, paragraph (b) of the text above now seems superfluous.

[7] Revenue Act of 1921, § 1101.

[8] Revenue Act of 1921, § 1106; Reg. 55 Rev., Arts. 176-7.

[9] Revenue Act of 1921, § 1107; Reg. 55 Rev., Art 177.

[10] Reg. 55 Rev., Art. 182.

[11] Reg. 55 Rev., Art. 181.

age stamps cannot be used for the payment of any internal revenue taxes.[12] Where documentary stamps are rendered useless by gumming or sticking together in transit or otherwise without the fault of the purchaser, they may be exchanged by a collector for other stamps of exactly the same quantity and denomination.[13]

WHERE STAMPS ARE AFFIXED. As a rule, stamps are affixed to the taxable document or instrument, but in some instances a different rule prevails, as will appear in the following paragraphs. Stamps to be affixed to articles manufactured in a foreign country and imported into the United States may be purchased and forwarded to the place of manufacture and there affixed to the articles before the same are packed for importation.[14]

WHO AFFIXES STAMPS. It is contemplated that stamps shall be affixed by the person issuing the document or instrument. Thus, the maker of a promissory note is primarily obliged to affix the proper stamp thereto, and likewise, the obligor should affix the proper stamp to a bond. However, it is secondarily the duty of a person accepting or receiving any such document or instrument to affix a stamp thereto and he is subject to penalty if he does not do so.[15] It has been held that it makes no difference who affixes the stamp, as long as a stamp of the proper denomination is affixed to the instrument. Both parties to a taxable instrument are responsible to the Government for affixing and cancelling stamps in the required amount. The law does not prohibit parties in interest from entering into an agreement as to which of them shall actually pay same.[16]

CANCELLATION OF STAMPS. Stamps are cancelled by the person using or affixing the stamp, by writing or stamping thereon or causing to be written or stamped thereon in ink his initials and the day, month, and year on which the stamp is used or affixed, or by cutting and cancelling the stamp with a machine or punch which will affix the initials and date as aforesaid and so deface the stamp as to render it unfit for reuse. In addition, stamps of the value of 10 cents or more are required to be cancelled by three parallel incisions made by some sharp instrument lengthwise through the stamp after the stamp has been attached to the instrument, except that this is not required where stamps are cancelled by perforation. The cancellation by either method

[12] Reg. 55 Rev., Art. 183.
[13] Reg. 55 Rev., Art. 184.
[14] Reg. 55 Rev., Art. 178.
[15] Revenue Act of 1921, § 1102 (a).
[16] Reg. 55 Rev., Art 171.

should not so deface the stamp as to prevent its denomination and genuineness from being readily determined.[17] The perforating machine may also imprint the initials and date or outline the same in small perforations, thus effecting complete cancellation, or the initials and date may be written on the stamp, and several perforations, sufficient to prevent washing and resale of the stamp may be made with an ordinary hand punch before fixing the stamp to the document.[18] Where the initials of a person, firm or corporation have been perforated on the stamps before being used it is sufficient when the stamps are actually attached to the document to stamp the same with the full initials and date. Where the initials of a firm or company have been stamped or written on a stamp it is not required that the individual employee affixing the stamp shall also place his own initials thereon.[19] It has been held that stamps on promissory notes were properly cancelled when they were so used and defaced that they could never be legally used again.[20] It has also been held that the failure to write the initials of the payee's name on a promissory note, when he was affixing a stamp and cancelling the same in the presence of the court before offering the note in evidence, did not affect its sufficiency.[21] In a case decided in 1865,[22] it was held that when a bond was executed by two obligors, it was sufficient if the stamp was attached and cancelled by one of them. A stamp affixed to an instrument and cancelled can not lawfully be removed therefrom and affixed to another instrument requiring a stamp. Amounts paid for stamps used in excess, or on instruments not actually effective and for which a substitute is prepared and stamped, or on instruments not subject to tax, may be refunded, upon claim properly presented to the collector.[23]

[17] Revenue Act of 1921, § 1104; Reg. 55 Rev., Arts. 179, 180.

[18] T. D. 2098.

[19] Letter from treasury department dated December 9, 1914.

[20] Taylor v. Duncan, 33 Tex. (1870) 440.

[21] Foster v. Holley's Adm'rs, 49 Ala. (1873) 593. The court in this case does not decide the question whether an improperly stamped note could be excluded from evidence in the state courts.

[22] Teagarden v. Garver, 24 Ind. 399. In this case, the court says: "The object of the Act of Congress is to raise revenue, and the stamps are required to be cancelled to prevent their use a second time. This was fully accomplished by one of the obligors cancelling it, as required by the Act of Congress." The court referred to the doubtful character of the power of the federal government to make a rule excluding improperly stamped instruments from evidence in the state courts, and the court's opinion indicates that this doubt was a factor in its decision. See p. 1242.

[23] Reg. 55 Rev., Art. 170.

Bonds of Indebtedness. Bonds, debentures or certificates of indebtedness, however termed, issued on and after April 1, 1919, by any person,[24] are taxable at the rate of 5 cents on each $100 of face value or fraction thereof.[25]

WHERE STAMPS ARE AFFIXED. The necessary revenue stamps may be affixed either to the bonds or to the indenture under which the bonds are issued. If the stamps are affixed to the indenture, the bonds must bear a legend showing that the proper revenue stamps have been affixed to the indenture and duly cancelled. If the indenture provides for the issue of bonds over a period of years, the necessary stamps may be affixed at the time of each issue.[26] If temporary bonds or interim certificates are first issued, to be later exchanged for permanent or definitive bonds, the stamps may be affixed to the indenture, in which case a statement that the stamps were affixed to the indenture must be printed or engraved on each bond.[27] No additional tax is required on the definitive or permanent bonds which, however, should bear notation of the fact that stamps in the proper amount were duly attached to the indenture or the interim certificates.[28]

It has been held that no stamp tax is due on the issue of definitive bonds after the incidence of the stamp tax where temporary bonds evidencing the loan receivable in two installments were issued and delivered before the incidence of the tax to the trustee pending payment of the two installments, receipts being given to individual creditors on payment of the first installment, the second installment being paid after the incidence of the tax.[29]

DEFINITIONS. Under the 1914 Law the tax was imposed only on bonds issued by corporations or associations. It is to be noted that the present act imposes the tax on bonds issued by persons which term includes corporations and partnerships as well as individuals.[30] There is no clear distinction between bonds of indebtedness and promissory notes, and it is sometimes difficult to determine whether an instrument should be taxed under the higher rate applying to bonds of indebtedness or the lower rate applying to promissory notes. An instrument which

[24] The term person includes partnerships and corporations as well as individuals. (Revenue Act of 1921, § 2).

[25] Revenue Act of 1921, Title XI, Schedule A-1.

[26] Reg. 55 Rev., Art 6; letter from treasury department dated May 24, 1919; W. T. S. 1919, § 3777.

[27] Reg. 55 Rev., Art. 7.

[28] T. D. 2164; T. D. 2220.

[29] Edwards v. Chile Copper Company, 273 Fed. 452.

[30] Revenue Act of 1921, Title XI, Schedule A-1.

is styled a "bond" and which is under seal will be held subject to tax as a bond unless it is shown affirmatively that it is not a bond.[31] If the instrument is called a note, but contains features not usual in or recognized as appertaining to the promissory note generally known to commerce, it is held in department practice to be taxable as a bond. Thus, under the 1914 Law it was held that an instrument designated as a "gold note" issued in the amount of $1,000, with interest coupons attached, and containing a promise by a corporation to pay a certain sum of money to the holder thereof under certain terms and conditions prescribed by the indenture of trust, was more in the nature of a bond or certificate of indebtedness than a promissory note and was, therefore, held taxable as a bond.[32] Instruments containing the essential features of a promissory note, but issued by corporations in series under a trust indenture, either in registered form or with coupons attached, embodying provisions for acceleration of maturity in the event of any default by the obligor, for optional registration in the case of bearer bonds, for authentication by the trustee, and sometimes for redemption before maturity, or similar provisions, are held to be bonds within the meaning of the statute, whether called bonds, debentures or notes.[33] The tax applies to bonds of indebtedness executed by the obligor and delivered to a bank or trust company as security for the payment of an obligation.[34] Bonds issued by life insurance companies in satisfaction of insurance policies are subject to tax.[35]

Bonds Given in a Penal Sum. An instrument under seal conditioned in a penal amount for the payment of a sum of money, such as often accompanies mortgages, is a bond for stamp tax purposes.[36] When a bond conditioned for the repayment or payment of money is given in a penal sum greater than the debt secured, the tax is based upon the amount secured and not upon the amount of the bond.[37]

Business Property Investment Bonds. Certificates commonly known as business property investment bonds are not subject to tax as bonds, debentures, or certificates of indebtedness, but are taxable as certificates of interest in property.[38]

31 Reg. 55 Rev., Art. 10.
32 T. D. 2257. See definition under Promissory Notes, p. 1213.
33 Reg. 55 Rev., Art. 8; T. D. 2713.
34 Reg. 55 Rev., Art. 16.
35 Reg. 55 Rev., Art. 18.
36 Reg. 55 Rev., Art 3; T. D. 2713.
37 Revenue Act of 1921, Title XI, Schedule A-1.
38 Reg. 55 Rev., Art. 11. See pp. 1175 and 1189.

EXEMPT BONDS. An instrument which merely represents the assignment of interest in a bond accompanying a mortgage is not taxable.[39] Bonds issued by school districts for school purposes are exempt from tax.[40] Certificates of deposit issued by banks and trust companies are held not to be taxable.[41]

ISSUE OF BONDS. Delivery is essential to constitute an issue of bonds.[42] It seems generally that the delivery of the bond establishes the date of issue. Thus, it was held under the 1914 Law that bonds certified and delivered by a trustee after the incidence of the tax were taxable although subscribed and paid prior thereto. Under the 1898 Law it seems to have been held that a bond was issued when delivery was made and the corporation received a benefit or a consideration therefor.[43] The date of renewal would be the date of issue for the purpose of the tax on a renewal of bonds.[44] Bonds issued by a domestic corporation in this country for sale to purchasers in a foreign country have been held to be issued here for the purpose of the tax, but bonds issued and sold by a domestic corporation in a foreign country have not been required to be stamped on the ground that the Government had no means of enforcing the statute in such case.[45] It has been ruled that bonds executed by a foreign corporation in a foreign country, certified to by a trustee in the United States, given for part of the purchase price of timber located in the foreign country, and delivered in the United States are subject to tax.[46]

TRANSFER OF BONDS. No tax is imposed upon the transfer of bonds, debentures or certificates of indebtedness from one holder to another.

RENEWAL OF BONDS. Every renewal of a bond, debenture or certificate of indebtedness is taxed as a new issue.[47] A renewal after April 1, 1919, of an instrument, issued prior thereto, will

[39] Reg. 55 Rev., Art. 12.

[40] Reg. 55 Rev., Art. 19.

[41] Reg. 55 Art. 13; T. D. 2054; letter from treasury department dated November 16, 1917; W. T. S. 1919, ¶ 3550. Such certificates were not taxed under the 1914 Law. See p. 1189.

[42] Reg. 55 Rev., Art. 1.

[43] Volume 1, Treasury Decisions No. 20156.

[44] Every renewal is taxed as a new issue. Revenue Act of 1921, Title XI, Schedule A-1.

[45] Letter from treasury department dated May 15, 1915.

[46] Reg. 55 Rev., Art. 17.

[47] Revenue Act of 1921, Title XI, Schedule A-1.

require the necessary revenue stamps.[48] An agreement extending a mortgage upon maturity, where a bond is secured by the mortgage and such agreement operates to renew the bond, subjects the latter to stamp tax as a renewal.[49] An agreement between the holder of a bond and the present owner of a parcel of real estate, extending maturity of a mortgage bond executed by a former owner, operates as a renewal, and such renewal is subject to tax. If in addition a new bond is given for the same indebtedness, it also is subject to tax.[50]

Bonds of Indemnity and Surety. Bonds of indemnity and surety are not subject to stamp tax under the Revenue Act of 1921. For a discussion of the taxation of such bonds under the 1918 Law the reader is referred to the 1920 edition of this book.

The following is the provision of the 1918 Law[51] taxing such bonds:

Bonds, indemnity and surety: On all bonds executed for indemnifying any person who shall have become bound or engaged as surety, and on all bonds executed for the due execution or performance of any contract, obligation, or requirement, or the duties of any office or position, and to account for money received by virtue thereof, and on all policies of guaranty and fidelity insurance, including policies guaranteeing titles to real estate and mortgage guarantee policies, and on all other bonds of any description, made, issued, or executed, not otherwise provided for in this schedule, except such as may be required in legal proceedings, 50 cents: *Provided,* That where a premium is charged for the issuance, execution, renewal or continuance of such bond the tax shall be 1 cent on each dollar or fractional part thereof the premium charged: *Provided further,* That policies of reinsurance shall be exempt from the tax imposed by this subdivision.

Building and Loan Associations. Stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, are not subject to the tax.[52] This provision of the law seems to exempt stock of such associations from the tax on original issue and also from the tax

[48] Reg. 55 Rev., Art. 2; Letter from treasury department dated December 11, 1917; W. T. S. 1919, ¶ 3548.

[49] Reg. 55 Rev., Art. 4. See Appeal of C. Bolte, 18 Haw. 241; In re. O. R. & L. Co., 19 Haw. 544.

[50] Reg. 55 Rev., Art. 5.

[51] Revenue Act of 1918, Title XI, Schedule A-2.

[52] Revenue Act of 1921, § 1101; Reg. 40 Rev., Art. 5.

on sales or transfers. Any instruments other than certificates of stock and bonds are not exempt.[53]

Bonds Given by United States, Foreign Governments and Political Subdivisions. All bonds given by the United States, or by any Foreign Government, or by any state, territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power are exempt from taxation.[54]

Capital Stock, Issue. Although the heading of this paragraph is that used in the statute, the language of the law is that the tax shall be imposed "on each original issue, whether on organization or reorganization, of *certificates of stock,* or of profits, or of interest in property or accumulations, by any corporation." The rate is 5 cents on each $100 of face value or fraction thereof except where the certificate is issued without face value, in which case the tax is 5 cents per share unless the actual value is in excess of $100 per share, in which case the tax is 5 cents on each $100 of actual value or fraction thereof, or unless the actual value is less than $100 per share, in which case the tax is 1 cent on each $20 of actual value, or fraction thereof.[55] The stamps representing this tax must be ordinary documentary stamps and are required by the law to be attached to the stock books and not to the certificates where issued.[56] Where the blank stock certificates are not kept in a stock certificate book the stamps should be affixed to the books of record in which the issue of stock is recorded.[57]

Contract to Issue Stock. It has been held by the Treasury Department that no stamps are required to be affixed to a contract or agreement by a corporation to issue stock.[58] Under a later ruling, however, stock is deemed to be issued when it is subscribed for and the subscription is accepted by the corporation regardless of the time of delivery of the certificate.[59] It is

[53] Under the 1914 Law it was held that notes given to or by such associations were taxable (T. D. 2112).

[54] Revenue Act of 1921, § 1101. See T. D. 2072.

[55] Under the 1918 Law, where certificates were issued without face value the tax was 5 cents per share, unless the actual value was in excess of $100 in which case they were taxed as under the present law (Revenue Act of 1918, Title XI, Schedule A-3).

[56] Revenue Act of 1921, Title XI, Schedule A-4; Reg. 40 Rev., Arts. 2, 3, 7, 8, 37.

[57] Letter from treasury department dated November 20, 1917; W. T. S. 1919, ¶ 3589.

[58] T. D. 2599.

[59] Reg. 40 Rev., Arts. 1, 33; Letter from treasury department dated March 25, 1920; W. T. S. 1921, ¶ 3614.

to be noted that the statute fixes a tax upon the *issue* of certificates of stock, etc., and the later ruling of the Treasury Department indicated above seems to be an unwarranted construction of the act.[60] It has been held that the "issue" of stock generally means the issue of the certificates.[61] But the word "issued" has been held in other connections to have no technical meaning, and stock has been held to be "issued" even though no certificates therefor have been made out or delivered.[62]

ORIGINAL ISSUE. The tax on the issue of capital stock is laid upon an excise or privilege of the corporation employed for its benefit.[63] The tax is laid upon the stock which a company originally issued and not upon certificates creating no addition to the total stock liability of the company. Where stock is issued with the right of conversion, and upon the exercise of this right stock of a different kind is issued to the stockholder so that in a sense the capitalization of the company is reclassified, no benefit accrues to the company and the transaction constitutes essentially nothing but an adjustment among the existing stockholders of rights which always attached to the original stock issue by virtue of the privileges of the charter of the corporation.

The issue by a corporation of certificates of preferred stock in lieu of outstanding certificates of common stock, or vice versa, or the issue of certificates of preferred stock of one kind in lieu of certificates of preferred stock of another kind, without other consideration and without change in the amount of the authorized capital stock of the corporation, is not subject to tax.[64] In

60 See Malley v. Bowditch, 259 Fed. 809, in which the court says in sustaining the constitutionality of the 1914 Law that "the stamp tax is contingent upon the original issue of a certificate of stock, just as a stamp tax on checks is contingent upon the issuing of checks." See also Edwards v. Wabash Ry. Co., 264 Fed. 610.

61 Edwards v. Wabash Ry. Co., 264 Fed. 610.

62 Flour City Nat. Bank v. Shire, 88 (N. Y.) App. Div. 401, 84 N. Y. Supp. 810, affirmed 179 N. Y. 587, 72 N. E. 1141; Amer. Pig Iron Co. v. State Board, 56 N. J. L. 389, 29 Atl. 160. In the latter case the court said: "The word 'issued,' as used in this connection, has no technical meaning. 'To issue,' as defined by lexicographers, signifies to send out; to put in circulation. In a popular sense, a corporation engaged in organization is said to issue stock when it obtains subscriptions for it, and in the construction of tax laws words are to be interpreted in their popular sense."

63 It has been stated that the 1914 stamp tax law is not a franchise tax or a corporation tax, but a stamp tax or document tax. (Malley v. Bowditch, 259 Fed. 809, approved in Edwards v. Wabash Ry. Co., 264 Fed. 610.)

64 Reg. 40 Rev., Art. 5, as amended by T. D. 3118.

other words, upon any reorganization,[65] only an original issue creating a new and further stock liability is subject to the stamp tax upon the issue of capital stock. The tax is designed to apply to the privilege of issuing stock in return for property against which the stock is first put out as an equivalent, and not to apply to subsequent issues based upon mere conversions, subdivisions, or re-classifications of the original total.[66]

A corporation had an original authorized capital stock of $7,000,000 divided as follows: First preferred stock of $1,000,000, second preferred stock of $1,500,000 and common stock,

[65] The term "reorganization" includes those business arrangements whereby the stock and bonds of a corporation are readjustment as to amount, income, or priority, or the property is sold to a new corporation for new stock and bonds, or is sold by the foreclosure of a mortgage upon it to a purchaser who buys for himself and his associates, and the various proceedings and transactions by which a succession of corporations is brought about, and also the proceedings by which existing corporations are continued under a different organization without the creation of a new corporation. (Reg. 40 Rev., Art. 33, as amended by T. D. 3118; See also Sol. Op. 71; W. T. S. 1921, ¶ 4114.)

[66] Reg. 40 Rev., Arts. 4 and 5; Wabash Railroad Co. v. Edwards, 264 Fed. 610. The decision in this case was based upon the 1917 Law and overruled T. D. 2752 dated August 20, 1918, by which it was held that the tax applied in the cases stated in the text above, and also that it applied to the issue of preferred and common stock whether or not exchanged for old stock upon a reorganization of a corporation, under § 24 of the New York Stock Corporation Law for the purpose of issuing stock without par value. The decision would not seem to affect that part of T. D. 2752 or that part of Reg. 40 Rev., Art. 4, which ruled that the tax applied to the issue of stock of either corporation in addition to its already existing stock upon a merger of trust companies under §§ 487 to 496 of the New York Banking Law, and to the new issue of stock by a consolidated corporation in exchange for stock of the consolidating corporations. The broad statement in Reg. 40 Rev., Art. 4, that the issue of certificates of stock upon reorganization by a corporation is subject to tax, is modified by this decision. The court found its decision largely upon the statutory rule of construction that a taxable statute is to be strictly construed against the government and in favor of the taxpayer. (See p. 1268.) And upon the further consideration that the 1917 Law was a re-enactment of a statute which had received a settled administrative construction by virtue of T. D. 20694, dated February 7, 1899, issued under the Spanish War Revenue Act of June 13, 1898, followed for many years until the enactment of T. D. 2752. In its opinion the court said: "And the tax is laid, not on each stock certificate that is issued, but on each original issue of certificates. The language is used to indicate the first issuance of the stock, and this is emphasized by the use of the words, in the same connection 'whether on organization or reorganization.' When a corporation issued for the first time a certificate of the stock, that certificate is an original issue. The tax is placed on the *original* issue. The word 'original' is defined by Webster as 'pertaining to the origin or beginning; preceding all; first in order.' "

$4,500,000. In March, 1920, the charter was amended to reduce the authorized capital stock of $5,250,000, divided as follows: Preferred stock, $1,500,000; common stock, $3,750,000, and new certificates were prepared showing the change in capitalization. At this time all of the first preferred stock had been retired, and there was outstanding of the original issue $4,500,000, made up as follows: Second preferred stock, $1,500,000; common stock, $3,000,000. The outstanding second preferred stock was non-cumulative and bore 6 per cent. interest and had a par value of $50 per share. The outstanding common stock also had a par value of $50 per share. The new preferred stock was 8 per cent. cumulative stock and had a par value of $100 per share, and the new common stock was of a par value of $100 per share. The new preferred stock was exchanged for the outstanding second preferred stock at the ratio of 1 share for 2, and the new common stock was exchanged for the old at the same ratio. The Treasury Department took the view that the new issue was subject to stamp tax. The new stock issued was stock which had never before been issued and was under an authorization not theretofore existing, but which arose out of the amendment of the charter. It constituted an original issue on reorganization. The total authorized capitalization of the corporation was changed and each share of the new stock, whether common or preferred, represented a fractional interest in a different capital stock. A new series of certificates was issued showing the change in the authorized capitalization and substituted for the outstanding certificates of the former corporation. The new preferred stock was cumulative convertible stock bearing 8 per cent. interest; the stock for which it was substituted was non-cumulative convertible stock bearing 6 per cent. interest; and the common stock in the reorganized corporation was issued subject to these different charges.[67]

Stock certificates issued in lieu of original certificates in a case where a corporation had changed its name are not taxable as an original issue,[68] and temporary or interim stock certificates issued before the permanent issues are taxable as original issue, but the subsequent exchange of such temporary certificates for definitive stock certificates to the same owner is not subject to any tax.[69] The issue of certificates of stock of a smaller denomination in exchange for outstanding certificates, where there is

67 Sol. Op. 71; W. T. S. 1921, ¶ 4007.

68 Reg. 40 Rev., Art. 5.

69 Reg. 40 Rev., Art. 5; T. D. 2584; Reg. 40 Rev., Art. 4.

no change in ownership or in the total amount of stock issued, is not subject to tax.[70]

The issue upon a merger of corporations of certificates of stock of the same kind in substitution for the old certificates of stock is not subject to tax.[71] The foregoing regulation has been held to exempt stock of the merging corporation (continuing corporation) from the original issue tax when exchanged for the old certificates of stock of such corporation, but not when exchanged for the old certificates of stock of the merged corporation or corporations.[72]

It was held under the 1914 Law that where bonds had been issued with the privilege of exchanging same for certificates of stock and the option was exercised after the incidence of the tax, the stock certificates then issued were taxable as original issue unless prior to the incidence of the tax the certificates in question had been issued and were held in trust for the purchaser of the bonds, in which case the rate of tax on transfers of stock was applicable.[73]

Certificates of Stock. The present law applies to the issue of (1) certificates of stock, (2) certificates of profit, and (3) certificates of interest in property or accumulations, issued by any corporation.[74] The 1917 Law applied only to certificates of stock. Under the 1914 Law, which taxed certificates of profit "or any certificate or memorandum showing an interest in the property or accumulations of any association, company or corporation, * * * " it was held that certificates issued by trustees to persons who had deposited certain securities, such certificates issued by the trustees showing such persons to be entitled to a part of the dividends, etc., accruing on account of the securities deposited, were taxable as certificates of profits.[75] Under the present law it seems that certificates evidencing an interest in profits or accumulations are not taxable unless issued by a "corporation," as that term is used in the law, but the Treasury Department has ruled that the issue to the beneficiary of certificates covering shares in the nature of shares of stock, where a number of persons pool their individual properties and appoint trustees having a definite term of office for the purpose of managing it and retain

[70] Reg. 40 Rev., Art. 5.

[71] Reg. 40 Rev., Art. 5.

[72] O. D. 83; Ruling No. 198, March, 1921; W. T. S. 1921, ¶ 4030.

[73] T. D. 2155.

[74] Revenue Act of 1921, Title XI, Schedule A-2; see Reg. 40 Rev., Art. 33.

[75] Reg. 40 Rev., Art. 4; Letter from treasury department dated July 26, 1916; W. T. S. 1916, p. 353.

certain rights of control over the property and a voice in the selection of the trustees who are authorized to issue the certificates, is subject to tax.[76]

ISSUED BY ANY CORPORATION. The term "corporation," as defined in Section 2 of the law, includes associations, joint-stock companies, and insurance companies.[77] It has been held that the tax applies to the issue of certificates of shares in so-called Massachusetts trusts and other unincorporated associations.[78]

STOCK OF DOMESTIC CORPORATIONS. The tax attaches to the issue of certificates of stock by a domestic corporation, no matter where the certificates are actually delivered.[79]

STOCK OF FOREIGN CORPORATIONS. Certificates of stock of foreign corporations sold or delivered within the United States are subject to the same tax as certificates of stock of domestic corporations. Stock of a corporation organized in a foreign country, issued in the United States, is subject to the tax on original issue.[80]

BUSINESS PROPERTY INVESTMENT BONDS. The issue by a corporation of business property investment bonds, or other instruments, wherein it is certified that the holder thereof is the owner of an interest in specified real property the legal title to which

[76] Reg. 40 Rev., Art. 4.

[77] See Reg. 40 Rev., Art. 4.

[78] T. D. 2752. It has been held that the 1914 Law does not impose a franchise tax or a corporation tax but imposes a stamp or document tax; that it follows from this consideration that whether the share capital is fixed by agreement or under statutory authority is immaterial and that the tax applies to certificates of shares issued by a manufacturing company organized in the form of a trust under the common law and deriving none of its rights, benefits or qualifications from any statute, and which was not an ordinary common law real estate trust. In other words, the word "stock" is to be interpreted in connection with the accompanying words of the statute "association, company, or corporation." It is a term not peculiar to corporations, but equally applicable to the share capital or fund created by or in accordance with an agreement for the formation of an unincorporated association or company. The difference between corporations and unincorporated associations being immaterial to the imposition of a stamp tax on documents, the different modes of realizing on the shares by the certificate holders is also immaterial. (Malley v. Bowditch, 259 Fed. 809; Edwards v. Wabash Ry. Co., 264 Fed. 610.) See also Crocker v. Malley, 249 U. S. 223. For a full discussion of the distinction between a "trust" and an "association," see Chapter 10.

[79] Reg. 40 Rev., Art. 4; Letter from treasury department dated July 24, 1918; W. T. S. 1919, ¶ 3588. This ruling was made in the case of stock issued in Cuba by a Delaware corporation, all of whose operations were carried on in Cuba. See p. 1168 as to bonds.

[80] T. D. 2073.

has been previously conveyed to a trustee and whereby the corporation issuing the same agrees to manage the property and distribute the proceeds in a certain manner is subject to tax.[81]

JOINT-STOCK LAND BANKS. The issue of certificates of stock by joint-stock land banks is subject to the stamp tax.[82]

PURCHASING BUSINESS OR ASSETS. The issue by a corporation of stock in exchange for property, real or personal, or for the purpose of purchasing the business or assets of another concern, is subject to tax.[83]

STOCK DIVIDENDS AND FRACTIONAL SCRIP CERTIFICATES. The issue of stock dividends and fractional scrip certificates is subject to tax.[84] Where scrip certificates for fractional shares of stock having a par value of $100 per share are issued the tax is at the rate of five cents for each certificate issued and not at the rate of five cents for each share of the total number of shares represented by the aggregate amount of scrip certificates issued.[85]

FEDERAL LAND BANKS. The issue of certificates of stock by Federal Land banks is not subject to tax.[86]

RIGHTS TO SUBSCRIBE TO STOCK. The issue of "rights" to subscribe for the stock by any corporation, joint-stock company or association evidenced by warrants is not subject to tax.[87]

VOTING TRUST CERTIFICATES. The tax does not apply to the issue of voting trust certificates representing stock certificates already issued.[88]

MEASURE OF TAX. The tax is measured, not by the amount paid in on, or for the stock, but by the face or par value of the stock, in the case of shares having a face or par value. The tax is imposed on the face or par value of the certificate and not upon the par value of each share. Thus, a certificate representing 10 shares of a par value of $10 each would be taxable as having a face or par value of $100. In the case of shares having no face or par value the tax is 5 cents per share, unless the actual value is in excess of $100 per share, in which case the tax is 5 cents on each $100 of actual value or fraction thereof, or unless the actual

[81] Reg. 40 Rev., Art. 4.

[82] Reg. 40 Rev., Art. 4.

[83] Reg. 40 Rev., Art. 4.

[84] Reg. 40 Rev., Art. 4.

[85] Telegram from treasury department dated January 9, 1920; W. T. S. 1921, ¶ 3565.

[86] Reg. 40 Rev., Art. 5.

[87] Reg. 40 Rev., Art. 5.

[88] Reg. 40 Rev., Art. 5; T. D. 2752.

value is less than $100 per share, in which case the tax is 1 cent on each $20 of actual value or fraction thereof.[89]

SHARES WITHOUT PAR VALUE. The actual value of shares without par or face value is a question of fact. For the purpose of this tax it may be determined by the statement of the company and the consideration involved in the issue of such stock,[90] or may be determined by the market price or otherwise.[91]

It has been ruled under the former law that the issue of a greater number of shares of no par value stock in lieu of a smaller issue of such shares, previously made, without any change in the amount of the capital assets of the issuing corporation, is subject to stamp tax in the amount of the difference between the tax computed upon such issue and the tax computed upon the issue which it replaces.[92] The issue on reorganization of a number of shares of no par value for each share of par value stock outstanding, without change in the amount of the authorized working capital, is subject to stamp tax in the amount of the difference between the tax computed upon such issue and the tax computed upon the issue which it replaces.[93]

Capital Stock, Sales and Transfers. The law provides for a tax on (a) all sales, (b) agreements to sell[94] or memoranda of

[89] Revenue Act of 1921, Title XI, Schedule A-2. Under the 1918 Law, in the case of certificates issued without face value the tax was 5 cents per share unless the actual value was in excess of $100 per share in which case the tax was 5 cents on each $100 of actual value or fraction thereof (Revenue Act of 1918, Title XI, Schedule A-3).

[90] Letter from treasury department dated November 26, 1917; W. T. S. 1919, ¶ 3592; Reg. 40 Rev., Art. 3.

[91] T. D. 2752.

[92] Reg. 40 Rev., Art. 4, as amended by T. D. 3118.

[93] Telegram from treasury department dated February 21, 1921; W. T. S. 1921, ¶ 4003.

[94] The term "agreement to sell" includes options, calls in "puts and calls," offers, indemnities and privileges, and contracts, either in writing or by parol, to sell on the deferred or partial payment plan (Reg. 40 Rev., Art. 33). In holding that a "call" was an "agreement to sell" under the 1898 Law the Supreme Court in Treat v. White, 181 U. S. 264, pointed out the distinction between an "agreement to sell" and an "agreement of sale" as follows: "That there is a difference between an agreement to sell and an agreement of sale is clear. The latter may imply, not merely an obligation to sell, but an obligation on the part of the other party to purchase, while an agreement to sell is simply an obligation on the part of the vendor or promisor to complete his promise of sale. That congress recognized the difference between these two terms is evident, because in the very next paragraph of Schedule A it provides, in reference to merchandise, for a stamp 'upon each sale, agreement of sale, or agreement to sell.' That no stamp duty was imposed on agreements to buy (or, in the vernacular of the stock exchange,

sales or deliveries of or transfers of legal[95] title to shares or certificates of stock in any association, company or corporation.[96] The tax is imposed whether or not the stock is represented by certificates,[97] and also whether or not the sale or transfer is shown by the books of the association, company or corporation, or is made by assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock[98] or not. In the case of stock having a par or face value, the amount of the tax is 2 cents on each $100 or fraction thereof of the total par or face value of the shares or certificates involved in the sale or agreement to sell, whether such aggregate par or face value is greater or less than $100; e. g., where the total par or face of the shares involved in the transaction is $100 or less, the tax is 2 cents; where such value is in excess of $100, the tax is 2 cents on each $100 or fraction thereof. Where one certificate represents several shares (however large the number of shares) on the transfer of such certificate the tax is computed upon its face value and not on the face value of each separate share of stock, or of profits, or of interest in property or accumulations; e. g., on the transfer of one certificate representing 500 shares, par value $5, the face value of the certificate being $2,500, the stamp tax is 50 cents.[99]

In the case of shares of stock without par or face value, the tax is 2 cents on the transfer or sale of, or agreement to sell, each share. The tax is measured, not by the amount paid in, on, or for, the stock, but by the face or par value of the stock in the case of shares having a face or par value, and by the number of shares in the case of shares having no face or par value.[100]

'puts') furnishes no ground for denying the validity of the stamp duty on agreements to sell."

[95] The word "legal" was first introduced in the 1917 Law and was not contained in the Act of October 22, 1914. (See Reg. 40 Rev., Art. 33.) Cf. § 270 of the New York State Tax Law and the case of Travis v. Ann Arbor Co., 180 N. Y. App. Div. 799, 168 N. Y. Supp. 53, affirmed 227 N. Y. 640, 126 N. E. 923.

[96] The law uses the word "corporation" but see the definition of this term in Revenue Act of 1921, § 2.

[97] Reg. 40 Rev., Art. 12; T. D. 2752.

[98] The Act of October 22, 1914, also read: "or to secure the future payment of money or for the future transfer of any stock."

[99] Reg. 40 Rev., Art. 11.

[100] Revenue Act of 1921, Title XI, Schedule A-3. Under the 1918 Law, where the actual value of shares without par or face value was in excess of $100, the tax was 2 cents on each $100 of actual value or fraction thereof. (Revenue Act of 1918, Title XI, Schedule A-4.)

Affixing and Cancellation of Stamps. In the case of the issue of shares of stock, whether on organization or reorganization, the stamps representing the tax should be affixed to the stock books and not to the certificates issued. In the case of a sale before certificates are issued, where the evidence of transfer is shown only by the books of the corporation, the stamps should be placed on such books. In case the change of ownership is effected by transfer or delivery of the certificate, i. e., where the name of the transferee is inserted in the indorsement or power of attorney on the back of the certificate, the stamp should be affixed to such certificate and cancelled by the person making the sale. In case of agreement to sell, or where the transfer is by delivery of the certificate assigned in blank, the stamp should be affixed to the bill, memorandum, or agreement to sell, and cancelled by the seller.[101]

It has been held by a state court under both the New York State tax on transfers of stock and the Federal Act on stock transfers that in the case of an agreement to transfer stock such laws are complied with if the requisite stamps be affixed and cancelled at the time the transfer is accomplished.[102]

In no event should any transfer agent or corporation accept or transfer any shares of stock or certificates unless stamps for all transfer tax required thereon have been properly affixed either to the certificates of stock or memoranda of sale, as the case may be, and duly cancelled. The person using or affixing the stamp should write or stamp thereon, in ink, his initials and the day, month, and year on which the same shall be affixed, or, by cutting or cancelling with a machine or punch, affix his initials and the date as aforesaid, and so deface such stamp as to render it unfit for reuse. In addition to the foregoing, stamps of the value of 10 cents or more should have three parallel incisions made with some sharp instrument lengthwise through the stamp after the same has been attached to the certificate, or bill, or memorandum, or other evidence of sale or transfer, unless the stamps are cancelled by perforation. The cancellation by either method should not so deface the stamp as to prevent its denomination and genuineness from being readily determined.[103]

[101] Reg. 40 Rev., Art. 37.

[102] Smythe v. Pure Ice Co., 193 App. Div. (N. Y.) 479; Phelps-Stokes Estates v. Nixon, 22 N. Y. 93, 118 N. E. 241; Waddle v. Cabana, 220 N. Y. 18, 114 N. E. 1054; Bean v. Flint, 204 N. Y. 153, 97 N. E. 490.

[103] Reg. 40 Rev., Art. 37; Letter from treasury department dated May 22, 1918; W. T. S. 1919, ¶ 3600.

SHARES WITHOUT PAR VALUE. The law provides that the tax shall be imposed at the rate of 2 cents a share on shares without par or face value.[104]

WHEN TAX ACCRUES. The stamp tax on sales or transfers of stock accrues at the time of making the sale or agreement to sell or memorandum of sale, or delivery of or transfer of the legal title to shares, or certificates of stock, or of profits, or of interest in property or accumulations in any corporation, joint-stock company, or association, or of the right to subscribe for or to receive such shares or certificates, regardless of the time or manner of the delivery of the certificate or agreement or memorandum of sale.[105]

WHERE TITLE TO THE STOCK PASSED PRIOR TO THE INCIDENCE OF THE TAX. No tax is imposed upon the transfer of such stock on the books of a corporation although made after the date on which the tax was first imposed.[106]

TAX PAID BUT ONCE. Where shares of stock are sold and the tax has been paid and stamps affixed to a bill or memorandum of sale, stamps are not again required when the transfer is made on the books of the company from the name of the party selling to the name of the purchaser.[107]

SHARES OR CERTIFICATES OF STOCK. The law imposes this tax on all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to "shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates."[108]

STOCK OF DOMESTIC CORPORATIONS. The tax attaches to the transfer of stock on the books of a domestic corporation, no matter where the sale is made or the stock certificates are delivered.[109]

[104] Revenue Act of 1921, Title XI, Schedule A-3. Under the 1918 Law if the actual value of such shares was in excess of $100 the tax was 2 cents on each $100 of actual value or fraction thereof (Revenue Act of 1918, Title XI, Schedule A-4).

[105] Reg. 40 Rev., Art. 9.

[106] Letter from treasury department dated November 30, 1917; W. T. S. 1919, ¶ 3590. This was also the rule under the 1914 Law.

[107] Reg. 40 Rev., Art. 13; T. D. 2073.

[108] Revenue Act of 1921, Title XI, Schedule A-3.

[109] Reg. 40 Rev., Art. 12; Letter from treasury department dated July 24, 1918; W. T. S. 1919, ¶ 3588. This ruling was made in the case of stock transferred in Cuba by a Delaware corporation, all of whose operations were carried on in Cuba.

STOCK OF FOREIGN CORPORATIONS. When certificates of stock of a foreign corporation are sold or delivered within the territorial jurisdiction of the United States they are subject to the same tax as certificates of stock of a domestic corporation.[110]

TRUSTS. The tax on the transfer of capital stock has been held to apply to the transfer of shares in so-called Massachusetts Trusts and other unincorporated associations.[111] In rulings issued under the 1918 Law it is held that the sale or transfer of certificates issued by trustees, where such trustees are appointed for a definite period and the declaration of trust provides that the beneficiaries (termed "stockholders") shall hold annual meetings for the election of new trustees to fill the vacancies thus accruing, the beneficiaries thus reserving to themselves control over the persons delegated to conduct their affairs and a voice in the business is subject to tax; but that the sale or transfer of certificates issued by trustees, where such trustees are legally appointed for the entire period of the trust and the beneficiaries retain no substantial control over the affairs of the trust, but delegate their proprietary functions to others, any further control on their part depending upon contingencies, their rights being limited to filling vacancies caused by death, resignation or disability is not subject to tax.[112]

TRANSFER OF STOCK BEFORE ISSUE OF CERTIFICATE. The existence of a stock certificate is not essential in order to make the transfer of shares subject to the tax. A transfer affecting a change of ownership of the share, whether made before or after the issuance of the original certificate, is taxable. Thus, the sale or transfer of temporary or interim certificates and the transfer of the interest of a subscriber for stock, however such interest may be evidenced or conditioned upon further payments, are subject to tax.[113] Under the 1914 Law it was held that transfers of subscription warrants entitling the holder to certificates of stock were taxable as transfers of stock.[114]

RIGHTS TO RECEIVE OR SUBSCRIBE FOR STOCK. Under the present law, transfers of rights to subscribe for or to receive shares or certificates of stock (or of profits or interest in property or

[110] Reg. 40 Rev., Art. 12; T. D. 2073.

[111] T. D. 2752.

[112] Reg. 40 Rev., Arts. 12, 13. For a full discussion of the distinction between a "trust" and an "association" see Chapter 10.

[113] Reg. 40 Rev., Art. 12; T. D. 2752; T. D. 2599.

[114] Letter from treasury department dated July 8, 1915.

accumulations) in any corporation whether or not evidenced by warrants are expressly made subject to tax.[115]

Where one corporation sold to another corporation certain property in consideration of the issuance to it of a fixed number of shares of the capital stock of the purchasing corporation, and thereafter, prior to the actual issuance of the stock certificates, the vendor corporation authorized the vendee corporation to issue the shares direct to the stockholders of the vendor corporation, the resolution of the board of directors of the vendor corporation conveying the authority is a transfer of the right to receive such shares, and the transaction is subject to the stamp tax.[116]

RIGHTS TO RECEIVE STOCK DIVIDENDS. The transfer of a right to receive a stock dividend already declared is taxable.[117]

VOTING TRUST CERTIFICATES. It has been held that: (1) The transfer of stock from stockholders to voting trustees is subject to tax, (2) the receipt of the certificates given by the voting trustees to the stockholders is not subject to tax, (3) any sale or transfer of such voting trust certificates by the owner is subject to tax, (4) the transfer by the voting trustees to the stockholders at the termination of the voting trust agreement is subject to tax.[118]

STOCKHOLDERS' COMMITTEES. A transfer of stock by individual stockholders to a committee of stockholders under a deposit agreement is subject to the stock transfer tax.[119] Transfers of certificates of stock to stockholders' committees for the protection of stockholders pending the receivership of a corporation are subject to tax.[120]

LOAN OF CERTIFICATES OF STOCK. The present law provides that no stamp tax shall be imposed upon mere loans of stock nor upon the return of stock so loaned.[121] The transfer of shares or certificates of stock in any corporation made by the person loan-

[115] Revenue Act of 1921, Title XI, Schedule A-3; Reg. 40 Rev., Arts. 12, 33. Letter from treasury department dated February 26, 1920; W. T. S. 1921, ¶ 3572; Letter from treasury department dated March 25, 1920; W. T. S. 1921, ¶ 3614.

[116] Marconi Wireless Telegraph Company of America v. Duffy, 273 Fed. 197.

[117] Reg. 40 Rev., Art. 12; T. D. 2752.

[118] Reg. 40 Rev., Art. 12; Reg. No. 40, Part 1, Art. 1; Letter from treasury department dated May 22, 1918; W. T. S. 1919, ¶ 3600.

[119] Letter from treasury department dated April 30, 1918; W. T. S. 1919, ¶ 3598.

[120] Letter from treasury department dated January 28, 1919; W. T. S. 1919, ¶ 3599.

[121] Revenue Act of 1921, Title XI, Schedule A-3.

ing stock to another borrowing the stock to effect a sale, and also the transfer of shares or certificates of stock from a borrower returning them to a lender in fulfillment of the borrower's obligation to buy in and return stock, are not subject to tax under the present law.[122] Under the 1918 Law it was held that in a so-called short sale transaction there were four taxable sales or transfers: (1) The sale of stock by the person making the short sale; (2) the transfer from the lender of stock to the person making the short sale so that he may make delivery of the stock sold; (3) the purchase by the borrower of stock to return to the lender; (4) the transfer from the borrower to the lender of shares to replace those borrowed.[123] Under the present law only transactions (1) and (3) will be taxable.

TRANSFERS TO AND BY FIDUCIARIES. Transfers of legal title are taxable, whether or not the transferee acquires any beneficial interest in the stock transferred. Thus, transfers from one trustee to another trustee under the same trust are subject to tax[124] and transfers from an executor or administrator to a trustee, and transfers from a trustee to the beneficiary under the trust are taxable, under the present law.[125]

Transfers of stock from one group of trustees to another group, although one or more of the trustees remains the same, is subject to tax. If transfer of title results wholly from operation of law, however, such transfer is not subject to stamp tax.[126] When stock stands in the name of two or more trustees, the nominal transfer of such stock to the surviving trustee or trus-

[122] Such transfers were held to be taxable under the 1918 Law. Reg. 40 Rev., Art. 12.

[123] T. D. 2685. Under the 1914 Law, certificates so loaned were not held taxable. (T. D. 2182.)

[124] Reg. 40 Rev., Art. 12; Letter from treasury department dated July 12, 1918; W. T. S. 1919, ¶ 3601.

[125] Reg. 40 Rev., Art. 12; Letter from treasury department dated July 1, 1919; W. T. S. 1919, ¶ 3974. Under the 1914 Law it was held that transfers from a deceased to his executor or administrator were not taxable. Transfers from a trustee to a substitute trustee were not taxable. Transfers from an executor or administrator to a trustee were taxable as were also transfers from the trustee to the beneficiary under the trust. It is to be noted that the words "legal title to" have been added to the Act of October 3, 1917 (see note 95 of this chapter), and therefore the fact that the trustee or nominee who transfers stock, and the party to whom title is transferred, both represent the same estate or beneficiary, does not affect the question, so long as the *legal title* is transferred. (Letter from treasury department dated July 12, 1918; W. T. S. 1919, ¶ 3601.)

[126] Letter from treasury department dated February, 1921; W. T. S. 1921, ¶ 4002.

tees upon the death of one of the trustees is not subject to the stamp tax.[127] It has been ruled that where new trustees are appointed under the Massachusetts Law[128] the transfer of stock from the names of the retiring trustees to the succeeding trustees is not subject to stamp tax since the newly appointed trustees acquire title to the trust estate by virtue of their appointment and without any formal conveyance.[129]

Transfers, however, of stock standing in the name of a deceased person to his executor or administrator are not taxable.[130]

TRANSFERS TO OR BY ALIEN PROPERTY CUSTODIAN. A transfer to the Alien Property Custodian of shares or certificates of stock in an American corporation in compliance with a demand made by him under authority of the Trading with the Enemy Act is the performance of a mandatory obligation, not voluntarily assumed, but imposed by the paramount authority of the Government and is therefore held not subject to the stamp tax. A sale by the Alien Property Custodian of shares or certificates of stock under the authority of the Trading with the Enemy Act, his agreement so to sell, and his transfer of legal title to certificates or shares so sold by him are held to be governmental acts in the administration of the Trading with the Enemy Act and therefore not subject to the stamp tax.[131]

BROKERS' INDIVIDUAL SALES. The sale, or agreement to sell, shares of stock made by a broker, directly or indirectly, for himself, and the sale or transfer of stock by a broker at a price different from that at which he accounts to his selling customer, are subject to tax.[132]

GIFTS. The transfer of stock in pursuance of a gift, bequest, or conveyance by trustees is subject to the tax.[133]

OTHER TRANSFERS WHERE CHANGE OF LEGAL TITLE ONLY TAKES PLACE. It has been recently held under the Stock Transfer Tax Law of New York (the language of which is similar to that of the federal law) that stock transfer taxes accrue upon the cancellation and surrender of a stock certificate standing in the name of an accommodation holder (nominal stockholder)

[127] Letter from treasury department dated March 31, 1921; W. T. S. 1921, ¶ 4026.

[128] Chapter 147, § 6, Revised Laws of Massachusetts.

[129] Letter from treasury department dated May 4, 1921; W. T. S. 1921, ¶ 4042.

[130] Reg. 40 Rev., Art. 13; Letter from treasury department dated July 1, 1919; W. T. S. 1919, ¶ 3974.

[131] Reg. 40 Rev., Art. 13; T. D. 2786.

[132] Reg. 40 Rev., Art. 12.

[133] Reg. 40 Rev., Art. 12.

and the making out of a new certificate in the place thereof in the name of another accommodation holder, and the endorsement of the new certificates in blank by the latter, the actual ownership of the stock at all times remaining in the same person. As there were two transfers of the legal title, two taxable transfers took place and a tax was required to be paid on each.[134]

FORMAL TRANSFERS WHERE NO CHANGE OF TITLE TAKES PLACE. The statute does not contemplate a tax unless there is a transfer of *legal* title to shares or certificates. Therefore, the tax on transfers of stock is not applicable to the surrender of old stock in exchange for new stock pursuant to a reorganization of a corporation.[135] The tax on transfers of stock does not attach to the exchange of stock certificates of the merged corporation for stock certificates of the merging corporation at the time and as a part of the merger nor to the substitution of new certificates for certificates representing old stock of the merging corporation.[136] Where, however, as under Section 15 of the New York Stock Corporation Law, providing for the merger of ordinary corporations, the acquisition of the stock of the corporation to be merged is a condition precedent to the merger, then the transfer of such stock to the merging corporation prior to the actual merger is taxable.[137] In the case of a consolidated corporation issuing stock in exchange for the stock of consolidating corporations the surrender of the stock of the consolidating corporations in exchange for the stock issued by the consolidated corporation is not a taxable transfer.[138] The tax does not apply to the surrender of certificates in exchange for other certificates representing the same or new stock, provided they are issued to the same holder.[139] The transfer of stock among the assets of the old corporation to a new corporation in a reorganization is subject to tax. If

134 New York State Tax Law, § 270. Travis v. Ann Arbor Co., 180 N. Y. App. Div. 799, 168 N. Y. Supp. 53, affirmed 227 N. Y. 640, 126 N. E. 923. The court said in this case: "The application of any other rule would be opposed to the plain wording of the statute, and furnish in many cases an easy method of evasion of the tax."

135 Reg. 40 Rev., Art. 13; T. D. 2752; letter from treasury department dated June 10, 1916. This is true in the case of a reorganization under § 24 of the New York Stock Corporation Law for the purpose of issuing stock without par value. For a definition of the term "reorganization" see note 65.

136 Reg. 40 Rev., Art. 13; T. D. 2752. This is true in the case of a merger of trust companies under §§ 487 to 496 of the New York Banking Law.

137 T. D. 2752; Reg. 40 Rev., Art. 12.

138 Reg. 40 Rev., Art. 13; T. D. 2752.

139 Reg. 40 Rev., Art. 13; T. D. 2752.

the new stock is issued to the old corporation the transfer of that stock from the old corporation to its stockholders is subject to tax. If the old stock is surrendered to the new corporation and constitutes it a corporate stockholder, that surrender is taxable.[140]

STOCK REDEEMED BY THE ISSUING CORPORATION. The tax on the transfer of capital stock does not apply to the surrender of stock certificates for retirement and redemption for cash. If, however, the corporation buys some of its own stock and transfers it to itself, whether or not it intends eventually to cancel it, the transfer to the corporation is subject to tax. The test is whether the immediate transaction results in the extinction of the stock or investing title to it in the corporation.[141]

DEPOSIT OF STOCK CERTIFICATES AS COLLATERAL SECURITY. No tax is intended to be imposed upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer or retransfer for such purpose of such stock certificates so deposited. In each such case, however, the person making a transfer of such certificates as collateral security must make and sign a statement of the facts and attach it to the certificate.[142] Under the 1914 law it was held that no tax was imposed on stock deposited as collateral until complete title to the certificates of stock was acquired by the pledgee.[143] This seems also to be the rule under the present law.

TRANSFERS TO OR BY A BROKER. No tax is imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased the same, but such deliveries or transfers must be accompanied by a certificate setting forth the facts.[144]

[140] Letter from treasury department dated February 26, 1920; W. T. S. 1921, ¶ 3567.

[141] Reg. 40 Rev., Arts. 12, 13; T. D. 2752; letter from treasury department dated June 20, 1918; W. T. S., 1919, ¶ 3597. Letter from treasury department dated February 26, 1920; W. T. S., 1921, ¶ 3572. Under the 1914 Law it was held that where stock was redeemed by a corporation the transfer from the stockholder to the corporation was subject to tax whether or not the stockholder merely surrendered the certificate for cancellation or executed the assignment on the back of the certificate. (Letter from treasury department dated January 20, 1916.)

[142] Revenue Act of 1921, Title XI, Schedule A-3. See Reg. 40 Rev., Art. 13; Reg. No. 40, Part I, Art. 5.

[143] Letter from treasury department dated December 28, 1915.

[144] Revenue Act of 1921, Title XI, Schedule A-3; Reg. 40 Rev., Art. 13. A rubber stamp with the name of the firm and address may be used in mak-

CERTIFICATE BY BROKER. The following forms have been prescribed for the use of brokers: (a) (in the case of a transfer to a broker) "We hereby certify that we have no ownership or interest, in * * * shares of the stock above transferred, the transfer by the owner to us being merely for the purpose of sale," (b) (in the case of a transfer by a broker) "We hereby certify that the transfer of * * * of the within shares to the names indicated by the star is made solely to complete the purchase made by us for our customer, and we have no ownership or interest therein." No broker who has filed a certificate under the foregoing clause (a) of this ruling should file a certificate under the foregoing clause (b) with reference to the transfer of any shares of stock covered by the certificates filed by him under clause (a).[145]

"CALLS." A "call" is an agreement to sell and is taxable; but a transfer of a certificate of stock pursuant to the "call" is not taxable, being only a fulfillment of the original agreement. The seller should execute and attach to the certificate of stock his certificate, which should be accepted by the transfer agent and should be preserved by him for inspection of the revenue officer. The certificate here prescribed should be in the following form:

We hereby certify that the transfer of.................. shares of the within stock of... has been made pursuant to a "call", and that the federal stock transfer stamps for the transaction are affixed to such "call", which is in our possession.[146]

TRANSFER TO CLEARING HOUSE. No tax is imposed upon transfers or deliveries to a clearing house for the sole purpose of clearing or adjusting accounts between members, where no beneficial interest is vested in said clearing house or clearing association and there has been no change of title or interest.[147]

INCONSISTENT BY-LAWS, RULES, OR CUSTOMS OF EXCHANGE. No provisions, by-laws, rules or customs of any exchange or similar institution inconsistent with any requirement or provision of the Revenue Act of 1918 or any regulations made thereunder, nor any collateral additional agreement or understanding, either verbal or written, respecting the subject-matter of sales or transfers of certificates, or the settlement or fulfillment thereof, which are inconsistent or in conflict with any requirement of said act or

ing such certificates (telegrams from treasury department dated April 19, 1921; W. T. S. 1921, ¶ 4036).

145 Reg. 40 Rev., Art. 13; Reg. No. 40, Part I, Art. 5.

146 Reg. 40 Rev., Art. 13.

147 Reg. 40 Rev., Art. 13; Reg. No. 40, Part I, Art. 5. A clearing house need not be incorporated and may be a part or department of an exchange or an independent body (Reg. 40 Rev., Art. 33). See p. 1225.

regulations will exempt any person from the payment of the tax imposed on sales or transfers of stock.[148]

SALE OF STAMPS. The ruling of the Treasury Department in regard to the sale of stock transfer stamps is given elsewhere in this book.[149]

REGISTRATION OF STOCK BROKERS. Stock brokers, transfer agents and clearing houses are required to register with the collector of internal revenue and to keep records of sales and transfers as is more fully set forth in a subsequent part of this chapter.[150]

Certificates of Profits. The 1898 Law and the 1914 Law taxed the original issue of a "certificate of profits, or any certificate or memorandum showing an interest in the property or accumulations of any association, company, or corporation, and on all transfers thereof." The 1917 Law was silent. The present law, like the 1918 Law, taxes the original issue of "certificates of * * * profits, or of interest in property or accumulations, by any corporation"[151] and the sale or transfer of legal title to "certificates * * * of profits or of interest in property or accumulations in any corporation."[152] In the present law the term "corporation" includes associations, joint-stock companies, and insurance companies. It seems, therefore, that certificates of profits or interest in property or accumulations are not taxed on original issue unless issued by a corporation, association, joint-stock company or insurance company, but the sale or transfer thereof may be taxed, if the certificate evidences an interest in the profits, property or accumulations of a corporation, association, joint-stock company or insurance company, regardless of who may have issued it. Thus, voting-trust certificates are not taxable on original issue, if they are issued by a trustee, but are subject to the tax on transfers when sold or transferred by the owner.[153] Under the 1914 Law it was held that certificates issued by trustees to persons who had deposited certain securities, showing such persons to be entitled to a part of the dividends accruing on account of the securities deposited were liable to the tax upon certificates of profit.[154]

[148] Reg. 40 Rev., Art. 14.

[149] See pp. 1235, 1238.

[150] See pp. 1224, 1236.

[151] Revenue Act of 1921, Title XI, Schedule A-2.

[152] Revenue Act of 1921, Title XI, Schedule A-3.

[153] Reg. 40 Rev., Arts. 5 (e), 12 (d). See, however, Reg. 40 Rev., Art. 4 (b), and the discussion upon this point at pp. 1174, 1176, 1181.

[154] Letter from treasury department dated July 26, 1916.

Business Property Investment Bond. A business property investment bond wherein it is certified that the holder thereof is the owner of an interest in certain specified real property, legal title to which has previously been conveyed to a trustee, and whereby the corporation issuing the same agrees to manage the property and distribute the proceeds in a certain manner, is not subject to tax as a bond, debenture, or certificate of indebtedness, but as a certificate of interest in property.[155]

Certificates of Deposit. A certificate of deposit is not subject to tax as a promissory note.[156] Certificates of deposit issued by banks and trust companies are not considered to be taxable as certificates of indebtedness, whether or not they are time certificates, or contain a clause reserving the right of thirty days' notice of payment.[157]

Morris-Plan Banks. Any instrument which is actually a certificate of deposit issued by a bank is exempt from stamp tax, regardless of whether it is negotiable or non-negotiable or whether it is payable on demand or at some specified time. Certificates of deposit issued by banks or organizations operating upon the Morris plan are not subject to stamp tax.[158]

Certificates of Indebtedness. A "certificate of indebtedness" is primarily any instrument acknowledging liability for the payment of money, not in the recognized form of a promissory note or bill of exchange.[159] The term "certificate of indebtedness" includes only instruments having the general character of investment securities, as distinguished from instruments evidencing debts arising in ordinary transactions between individuals.[160]

Trust certificates, commonly known as "Car Trust Certificates" issued under the Pennsylvania plan have been held to be subject to stamp tax as "certificates of indebtedness."[161] See Bonds of Indebtedness.

Scrip-Dividend Certificates or Warrants. Scrip-dividend certificates or warrants are taxable as certificates of indebtedness.[162]

155 Reg. 55 Rev., Art. 11.

156 Reg. 55 Rev., Art. 62.

157 Letter from treasury department dated November 16, 1917; W. T. S. 1919, ¶ 3550.

158 Reg. 55 Rev., Art. 13.

159 T. D. 2713.

160 T. D. 2919; Reg. 55 Rev., Art. 4.

161 Fidelity Trust Company v. Lederer, U. S. Dist Ct., Eastern Dist. of Pennsylvania, decided July 14, 1921.

162 Reg. 55 Rev., Art. 9.

CERTIFICATES OF INDEBTEDNESS ISSUED BY RECEIVERS. A certificate of indebtedness issued under order of a Federal court by a receiver is subject to tax.[163]

CONDITIONAL BILLS OF SALE. Conditional bills of sale used in sale of merchandise on the installment plan are not certificates of indebtedness within the meaning of the law, and are not subject to stamp tax, unless in the form of promissory notes.[164]

Certificates Generally. No tax is imposed under the present law on certificates of incorporation, certificates of damage and certificates generally.

Checks. No tax is imposed on checks payable at sight or on demand. Only drafts or checks expressly payable otherwise than at sight or on demand are taxable.[165] See Promissory Notes.

Contracts. No tax is imposed by the present law on contracts as such.[166]

Conveyances. The law taxes any deed, instrument or writing, whereby any lands, tenements, or other realty *sold* shall be granted, assigned, transferred or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons by his, her or their direction. The tax is based upon the consideration or value of the interest or property conveyed, exclusive of the value of any lien or incumbrance *remaining thereon at the time of sale*.[167] The rate is as follows: When such consideration or value does not exceed $100, no tax; exceeding $100 and not exceeding $500, 50 cents; for each additional $500 or fractional part thereof, 50 cents. The rates were the same under the 1918 Law. The tax does not apply to any instrument or writing given to secure a debt.[168]

WHO AFFIXES STAMPS. The person who makes, signs or issues the deed (i. e., the grantor) is required to affix the stamps thereto and becomes primarily liable to penalty if stamps in a sufficient amount based upon the actual value of the consideration given are not so affixed.[169] The law also prohibits any person from accepting such instruments unless they are properly stamped. The grantee in a deed is liable for the tax as well as the grantor.[170]

[163] Reg. 55 Rev., Art. 15.
[164] Reg. 55 Rev., Art. 14.
[165] Reg. 55 Rev., Art. 63.
[166] T. D. 2599.
[167] Revenue Act of 1921, Title XI, Schedule A-6. See Central Trust Co. v. Columbus, etc., Co., 92 Fed. 919.
[168] Revenue Act of 1921, Title XI, Schedule A-6.
[169] Reg. 55 Rev., Art. 66; T. D. 2115; T. D. 2283.
[170] Reg. 55 Rev., Art. 66.

Where a purchaser has accepted an unrecorded deed he may be compelled to pay the required tax before having the deed recorded, or prosecuted under Section 1102 of the law.[171] In a case where the referee at a foreclosure sale did not affix the stamps required by law but the purchaser affixed such stamps under protest before recording the deed, it was held that the grantee, vendee or any other person participating in the making or issuing of a paper without revenue stamps may be required to pay the tax thereon and is liable for failure to do so.[172]

Where Stamps Are Affixed. The stamps should be affixed on the deed or other instrument conveying the real estate.[173]

When Tax Accrues. The time of delivery of a deed conveying real estate determines its taxability. Deeds executed and delivered on or after April 1, 1919, conveying property in pursuance of a contract made prior to that time are taxable, and deeds executed and delivered prior to such date are not taxable,[174] even though they are recorded after that date.[175] The same rule applies to similar deeds delivered prior to April 1, 1919, and taxable under the 1917 Law. A deed dated prior to April 1, 1919, but delivered subsequent to that date, is taxable. If delivered between December 1, 1917, and April 1, 1919, it is taxable under the 1917 Law.[176] Deeds in escrow become subject to stamp tax upon delivery to the grantee. If delivered between December 1, 1917, and April 1, 1919, they are taxable under the 1917 Law; if delivered on or after April 1, 1919, they are taxable under the Revenue Act of 1918.[177] Deeds delivered after the incidence of the tax must be stamped although they may have been dated, executed and acknowledged prior thereto and even though delivered prior thereto to a third party for account of the grantee named in the deed, if delivery by such party to the grantee is made after the incidence of the tax.[178] A conveyance of property subject to an equity of redemption is taxable when made, not when the time for the equity of redemption has expired.[179]

Consideration or Value. The tax is imposed upon the full amount of consideration or value although payments may have

[171] See p. 1239. See letter from treasury department dated May 27, 1918; W. T. S. 1919, ¶ 3717.

[172] T. D. 2310; Home Title Insurance Company v. Keith, 230 Fed. 905.

[173] Reg. 55 Rev., Art. 68; T. D. 2599.

[174] Reg. 55 Rev., Art. 71; T. D. 2115.

[175] T. D. 2115.

[176] Reg. 55 Rev., Art. 72.

[177] Reg. 55 Rev., Art. 73; T. D. 2115; Vol 2, T. D. (1898) No. 20,096.

[178] T. D. 2042.

[179] Reg. 55 Rev., Art. 78.

been made upon the installment plan prior to the incidence of the tax.[180] When the consideration for a conveyance of lands, tenements or other real property is left open, to be fixed by future contingencies, the actual value at the time of conveyance is the measure of the tax upon the deed, instrument or writing whereby the conveyance is made.[181] Quit-claim deeds are taxable according to the value of the interest conveyed.[182] Stock in a corporation is a valuable consideration for the transfer of real property, and a deed conveying real estate to a corporation for such consideration is taxable.[183]

The conveyance of real property in a reorganization from the old corporation to the new organization in consideration of the issue of new stock to the old corporation or to its stockholders is subject to stamp tax on the basis of the value of the property.[184]

A conveyance of real estate by co-owners to a corporation organized for convenience in handling the property, made in consideration of the issue to them of the corporation's capital stock, is subject to tax.[185] A deed from a corporation, the entire capital stock of which is owned by another corporation, conveying real estate to the latter in consideration of the payment by the grantee of all obligations of the grantor is subject to tax.[186] The value of the interest in the property conveyed determines the amount of the tax.[187] A conveyance of land in consideration of life maintenance is taxable, the tax to be measured by the value of the property or interest conveyed.[188] Where a deed states that the transfer is made for a nominal consideration the tax must be computed upon the actual value of the interest or property conveyed.[189] Conveyances of realty, not in connection with a sale, to trustees or other persons without consideration are not taxable.[190] Taxes and assessments which have become a lien on real estate by operation of statute and which are not paid at the time of sale are deductible from the consideration in computing the stamp

[180] T. D. 2279.

[181] Reg. 55 Rev., Art. 67.

[182] Reg. 55, Art. 82; T. D. 20,232.

[183] Reg. 55, Art. 81.

[184] Letter from treasury department dated February 26, 1920; W. T. S. 1921, ¶ 3567.

[185] Reg. 55, Art. 101.

[186] Reg. 55, Art. 107.

[187] T. D. 2278.

[188] Reg. 55, Art. 79.

[189] T. D. 2115.

[190] Reg. 55, Art. 95.

tax.[191] Where a parent company decided to dissolve some of its subsidiaries and to take over their real property, deeds of conveyance having been prepared for a nominal consideration, no actual consideration passing to the subsidiary companies, it has been ruled that such deeds are not subject to stamp tax.[192]

REALTY SOLD. The law provides that deeds whereby any realty sold shall be conveyed to another are taxable. Hence, it seems that if the realty is not sold, no stamps need be affixed to the deed. The word "sold" is used in its ordinary and popular meaning,[193] and imports the transfer of the absolute or general title for a valuable consideration or price.[194] Deeds on an exchange of property are, however, subject to tax which should in each case be computed on the basis of the actual value of the interest on the property conveyed, the amount of any pre-existing lien or encumbrance which is not removed by the sale being deductible.[195] Deeds that are only confirmatory and which do not vest title not already vested are not taxable.[196]

Contracts for the sale of real property are not taxable unless they vest title.[197]

The following kinds of deeds are also not taxable: (1) Quitclaim deeds given for no consideration, or merely for the nominal consideration of $1.00, for the purpose of correcting flaws in title,[198] (2) partition deeds which are operative in defining boundary lines or in showing by location the interests of the tenants-in-common,[199] unless a consideration passes between the parties by reason of one or more of them taking under the division a share of real estate of greater value than his individual interest, in which event stamp tax attaches to the deeds conveying such greater shares, calculated upon the value of such consideration,[200] (3) deeds of release,[201] (4) deeds of trust,[202] (5) deeds issued to cover pure and *bona fide* gifts of property from husband to wife

[191] Reg. 55, Art. 109.

[192] Letter from treasury department dated April 18, 1919; W. T. S. 1919, ¶ 3770.

[193] See p. 1262.

[194] Reg. 55 Rev., Art. 70.

[195] Reg. 55 Rev., Art. 75; T. D. 2599; T. D. 2111.

[196] Reg. 55 Rev., Art. 97; Circular No. 503, 2d revision. Compilation of decisions for year 1899, p. 293.

[197] Reg. 55 Rev., Art. 98.

[198] Reg. 55 Rev., Art. 82; T. D. 2115.

[199] T. D. 2115.

[200] Reg. 55 Rev., Art. 94.

[201] Reg. 55 Rev., Art. 84; T. D. 2115.

[202] Reg. 55 Rev., Art. 84; T. D. 2115.

or from parent to child, or from an individual to a municipality or other political subdivision, or to the United States, wherein the consideration named is "natural love and affection and $1.00," "desire to promote public welfare and $1.00," or "$1.00 and other valuable consideration,"[203] (6) deeds not granting, assigning, transferring or conveying to the purchasers any lands, tenements, or other realty, but only the right to sepulture or burial, to erect monuments, etc.,[204] (7) deeds of reconveyance by an agent to an undisclosed principal if no consideration, or a nominal consideration of $1.00 only is given,[205] (8) deeds executed by debtors covering assignments of property to trustees to be held for the benefit of creditors,[206] (9) deeds given by a husband and wife to a "straw man" who immediately executes a deed reconveying the property to the husband or wife, if no valuable consideration, or merely the nominal consideration of $1.00 is given, and likewise the deeds of reconveyance,[207] (10) deeds transferring title to property to building and loan association for the purpose of securing a loan on the property so conveyed, which property is immediately reconveyed to its owner, and likewise the deeds of reconveyance,[208] (11) conveyances of property of a copartnership, in the hands of receivers, back to the owners after administration of the estate,[209] (12) deeds by an executor to devisees, conveying specific parcels of real estate, devised to them in common, unless a consideration passes between the devisees by reason of some of them taking a greater share in the real estate than that to which entitled under the will, in which event tax attaches to the deeds conveying such greater shares, and is calculated upon the amount of value of such consideration,[210] (13) conveyances to a trustee without valuable consideration or from a trustee to a *cestui que trust* without valuable consideration,[211] (14) a conveyance of real estate by a corporation without valuable consideration to an owner of all its capital stock in consequence of its dis-

[203] Reg. 55 Rev., Art. 88; T. D. 2115.

[204] Reg. 55 Rev., Art. 87; T. D. 19,838.

[205] T. D. 2115; Reg. 55 Rev., Art. 92.

[206] Reg. 55 Rev., Art. 89; T. D. 2115. When, however, the trustee sells or conveys such property either to the creditor, or any other person, the deeds executed by him are taxable. Reg. 55 Rev., Art. 89; T. D. 2115.

[207] Reg. 55 Rev., Art. 91; T. D. 2115.

[208] Reg. 55 Rev., Art. 90; T. D. 2115. But deeds of building and loan associations are taxable. (Reg. 55, Art. 80.)

[209] Reg. 55 Rev., Art. 93.

[210] Reg. 55 Rev., Art. 102.

[211] Reg. 55 Rev., Art. 105.

solution.[212] Where an officer of a corporation purchases real estate from the corporation, conveyance being first made to a third party as part of the same transaction, the property is conveyed by the third party to the officer, the conveyance to the third party is subject to tax, while the conveyance from the third party is not subject to tax.[213]

CONVEYANCE OF DOWER. In states where common-law dower still exists an instrument purporting to convey the inchoate right of dower of a wife or the consummate right of dower of a widow, prior to assignment of dower, is not subject to stamp tax; but an instrument conveying the estate acquired by a widow upon assignment of dower is subject to tax. Where by statute dower has been abolished and a different interest in the husband's real property conferred upon the wife in lieu thereof, the taxability of an instrument purporting to convey such an interest prior to its assignment will be determined by the nature of the wife's interest, and the statutes and decisions of the particular state in which the real estate is located must be consulted.[214]

INCUMBRANCE ON PROPERTY AT THE TIME OF SALE. The consideration or value on which the tax is based is exclusive of the value of any lien or incumbrance *remaining* thereon *at the time of sale.* The words in italics were not contained in the former law and were inserted to limit the exclusion to liens or incumbrances other than purchase money mortgages. In determining the amount of incumbrances upon real estate being transferred, no consideration is to be given to new incumbrances placed upon same at the time of, or after, the sale. Incumbrances placed on the property in connection with and as a result of the sale or transfer, as well as notes for deferred payments, cannot be deducted in determining the amount on which the tax is calculated. Only incumbrances which rest on the property before the sale and which are not removed by the sale are to be taken into consideration.[215]

ABSTRACTS OF TITLE. Abstracts of title are not taxable.[216]

CONTRACTS TO CONVEY. A contract for the sale of real estate, making provision for future delivery by deed, is not subject to stamp tax.[217]

212 Reg. 55 Rev., Art. 103.
213 Reg. 55 Rev., Art. 110.
214 Reg. 55 Rev., Art. 76.
215 Reg. 55 Rev., Art. 68; T. D. 2599.
216 Reg. 55 Rev., Art. 99.
217 Reg. 55 Rev., Arts. 83, 98; T. D. 2599; T. D. 2115.

MINING DEEDS. Deeds conveying mines are taxable.[218] A conveyance of a mine located on unpatented land is subject to taxation.[219] This ruling was made under the 1898 Law. Under the 1914 Law, it was held by the Treasury Department in an informal ruling that deeds to mining claims prior to the issue of the patent were taxable upon transfer as conveyances of real property. The tax should be computed upon the interest in the property conveyed which would be the market value of the stock issued therefor, or if it had no market value, the cash value of the mining claim.[220]

CONVEYANCE BY MORTGAGOR TO MORTGAGEE. A conveyance by a defaulting mortgagor to the mortgagee in consideration of the cancellation of mortgage debt is subject to tax calculated upon the amount of the mortgage debt plus unpaid accrued interest.[221]

TIMBER DEEDS. Standing timber is ordinarily held to be real estate. The question of whether or not a particular instrument of grant is taxable depends on whether or not the subject matter of the grant is real estate. What is real estate is determined by the law of the state in which the property conveyed is situated.[222] It is held that a timber deed transferring timber upon a tract of land is a deed of realty and as such is taxable, unless timber is not real estate under the laws of the state in which the property is located.[223]

LEASES. Leases of real property are not subject to tax.[224] Operating leases of oil and mining properties, long-term mining leases, etc., which in themselves convey no title to or interest in real property, are exempt from taxation.[225]

OPTIONS. No tax is imposed upon an option for the purchase of real property.[226]

DEEDS GIVEN BY AND TO UNITED STATES AND POLITICAL SUBDIVISIONS. Deeds executed by the United States or by any state, county, town or other municipal corporation, are not taxable.[227] Deeds executed by a state, county, or municipal officer conveying

[218] Reg. 55 Rev., Art. 77.
[219] Vol. 1, Treas. Dec. (1899), No. 20,986.
[220] Letter from treasury department dated August 3, 1916.
[221] Reg. 55 Rev., Art. 104.
[222] Reg. 55 Rev., Art. 76.
[223] Letter from treasury department dated Feb. 15, 1918; W. T. S. 1919, ¶ 3714.
[224] Reg. 55 Rev., Art. 100.
[225] T. D. 2155; T. D. 2599.
[226] Reg. 55 Rev., Art. 83; T. D. 2115.
[227] T. D. 2283. See Revenue Act of 1921, § 1101.

realty sold for non-payment of taxes are not subject to tax.[228] Deeds conveying to a state real estate purchased by it are not subject to tax.[229] A conveyance of real estate sold to the United States Government is subject to tax.[230]

DEEDS GIVEN BY OFFICERS OF COURTS. Stamps should be attached to masters' deeds made pursuant to decrees of the United States District Courts. The execution of such conveyances is not a judicial function, the title to the land being conveyed to the purchaser at the foreclosure sale through the master instead of the defendant himself making the sale. The cost of such stamps should be taxed as a part of the cost of the case.[231] The stamp tax on a deed of real property executed by a sheriff, referee, or commissioner to a mortgagee who bids in a property at a foreclosure to satisfy the mortgage should be computed upon the amount bid for the property, plus the costs if paid by the purchaser.[232] Deeds executed by masters in chancery, sheriffs, clerks of courts, etc., to cover transfers of property sold under a foreclosure or execution are subject to tax. The grantee or vendee may be required to pay the tax or cost of revenue stamps may be included in the expense of the foreclosure sale.[233] Judgments or decrees of the State court operating to transfer title to real estate are not taxable as conveyances.[234]

CONVEYANCE TO OR BY ALIEN PROPERTY CUSTODIAN. A conveyance of realty to the Alien Property Custodian in compliance with a demand made by him under authority of the Trading with the Enemy Act is held not subject to the stamp tax for the reason that such a conveyance is the performance of a mandatory obligation, not voluntarily assumed, but imposed by the paramount authority of the government, and for the further reason that it is not a conveyance of "realty sold." A conveyance by the Alien Property Custodian of realty sold by him under authority of the Trading with the Enemy Act is held not to be subject to the stamp tax for the same reason, and for the further reason

228 Reg. 55 Rev., Art. 85.

229 Reg. 55 Rev., Art. 86.

230 Reg. 55 Rev., Art. 106.

231 T. D. 2111; T. D. 2253; Crawford v. New South Farm and Home Co., 231 Fed. 999. This case was decided under the 1914 Law and it was held that the decision in Farmers Loan and Trust Company v. Council Bluffs Gas and Electric Company, 90 Fed. 806, decided under the 1898 Law, was applicable.

232 Reg. 55 Rev., Art. 69.

233 Reg. 55 Rev., Art. 74.

234 Reg. 55 Rev., Art. 108.

that it is an instrument issued by the United States in the exercise of a strictly governmental function.[235]

PROPERTY IN A FOREIGN COUNTRY. A deed conveying real estate lying in countries which are not United States territory is not subject to tax although the grantor and grantee may both be citizens and residents of the United States.[236]

Debentures. The term "debenture" ordinarily, although not necessarily, refers to an unsecured bond.[237] See Bonds of Indebtedness.

Drafts. Drafts drawn at sight or on demand are not taxable.[238] But drafts drawn otherwise than at sight are generally taxable. The taxability of a draft is determined by the face or form of the instrument and not by any understanding between the maker and the drawee.[239] For the rate of tax and a discussion of the rulings regarding taxable drafts see Promissory Notes.

Entry for Withdrawal of Goods or Merchandise from Customs Bonded Warehouse. The tax on instruments of this character is 50 cents.[240] Under the 1914 Law it was held that withdrawals for exportation were not taxable in view of the constitutional provision prohibiting taxation upon exports.[241] It was also held that where entries were filed in duplicate, triplicate, etc., a stamp was required on the original copy only.[242]

Entry of Goods, Wares or Merchandise at Customhouse. The law provides that entry of any goods, wares or merchandise at any customhouse, either for consumption or warehousing, shall be taxed as follows: Not exceeding $100 in value, 25 cents; exceeding $100 and not exceeding $500 in value, 50 cents; exceeding $500 in value, one dollar.[243] Customhouse entries made by United States officials traveling as such on Government funds are not taxable. Likewise entries made by all representatives of foreign countries in their official capacity are by comity exempt.[244]

[235] T. D. 2786.

[236] Reg. 55 Rev., Art. 96; Volume 2, T. D. (1898) No. 21,562. This was also the rule under the act of October 22, 1914.

[237] T. D. 2713.

[238] Revenue Act of 1921, Title XI, Schedule A-5; Reg. 55 Rev., Art 33.

[239] See p. 1217.

[240] Revenue Act of 1921, Title XI, Schedule A-8; Reg. 55 Rev., Art. 112.

[241] T. D. 35,007. See U. S. v. Hvoslef, 237 U. S. 1, and paragraph on Constitutionality of Stamp Taxes.

[242] T. D. (Customs) 35,040. See Wright v. Michigan Central Co., 130 Fed. 843.

[243] Revenue Act of 1921, Title XI, Schedule A-7.

[244] Reg. 55 Rev., Art. 111. It was so held under the 1914 Law. (T. D. Customs, 3572.)

Foreign Insurance Policies. A tax of 3 cents on each dollar or fractional part thereof of the premium charged is imposed on each policy of insurance or certificates, binder, covering, note, memorandum, cablegram, letter or other instrument by whatever name called whereby insurance is made or renewed upon property within the United States (including rents and profits) against peril by sea or on inland waters or in transit on land (including trans-shipments and storage at termini or way points) or by fire, lightning, tornado, windstorm, bombardment, invasion, insurrection or riot, issued to or for or in the name of a domestic corporation or partnership or an individual resident of the United States by any foreign corporation or partnership or any individual not a resident of the United States, when such policy or other instrument is not signed or countersigned by an officer or agent of the insurer in a state, territory, or district of the United States within which such insurer is authorized to do business. Policies of re-insurance are exempt from this tax[245]

DEFINITIONS. The following terms are defined as indicated below: (a) "insurer" includes any person, copartnership, association, or corporation transacting the business of insurance, and also any agent or broker, wherever applicable; (b) "insurance" includes every manner of providing indemnity against risks upon property of any description (including rents and profits) from peril by sea or inland waters or in transit on land (including trans-shipments and storage at termini or way points) or by fire, lightning, tornado, windstorm, bombardment, invasion, insurrection, or riot; (c) "policy of insurance" includes any instrument by whatever name the same is called whereby insurance is made or renewed by the insurer, as policies, binders, certificates, open policies, covering notes, memoranda, cablegrams or letters; (d) "other instrument" includes any instrument by which insurance is made or renewed, i. e., by which the relationship of insurer and insured is created or evidenced, whether it be a letter of acceptance, cablegram, or other instrument by whatever name called; (e) the expression "whereby insurance is made or renewed" includes any evidence or confirmation of a binding contract of insurance whereby a risk is assumed by the insurer; (f) "issue" means the act whereby insurance is made or renewed or in any manner becomes a binding contract effective for insurance; (g) "premium charged" means the total premium payable during the life of a contract of insurance and shall include any additional assessment or charge in the nature of a premium which may be assessed or charged during the life of a contract of

245 Revenue Act of 1921, Title XI, Schedule A-13.

insurance, whether payable in one sum or in installments and however paid (and though never paid if the contract of insurance be delivered and accepted or otherwise becomes binding upon the insurer); (h) "premium" means the agreed price for assuming and carrying the risk. It includes all that is received by the underwriter therefor and is in fact the total consideration receivable for underwriting the risk, whether in one sum or in installments, during the life of the policy; (i) "United States" includes the States of the United States, the Territories of Alaska and Hawaii, and the District of Columbia.[246]

Effective Date. Policies of insurance which are issued and accepted on and after April 1, 1919, regardless of when the insurance thereunder becomes effective, are subject to tax; but policies which were issued and accepted prior to April 1, 1919, if issued in the usual course of business and according to general custom and not for the purpose of evading the tax, are not subject to tax.[247]

Persons Liable to Tax. The insurer, the agent, or broker, effecting, accepting, placing or soliciting the insurance, and also the insured are each liable for the tax.[248]

What Instruments Must Bear a Stamp. The stamp must be affixed to the first instrument by which the insurance is made or renewed, i. e., by which the relationship of insurer and insured is created or evidenced, whether it be a letter of acceptance, cablegram, or other instrument by whatever name called. In the case of so-called "open policies" or "open cargo covers," where the amount of the premium is not definitely determined at time of issuance, the stamps may be affixed to the receipts for monthly or other payments if proper notation be made upon such receipts identifying the original instruments to which they apply. In the case of a binder or other instrument whereby insurance is made or renewed, issued without agreement as to the premium to be charged, stamps must be affixed when the amount of the premium is determined.[249]

Insured to Retain Policy for Two Years. The person having control or possession of a policy of insurance or other instrument to which documentary stamps shall be affixed according to law shall retain such instrument for the period of two years from the date of issuance thereof, for the purpose of

246 Reg. 55 Rev., Art. 156.
247 See Reg. 55 Rev., Art. 156.
248 Reg. 55 Rev., Art. 157; Reg. 55 Rev., Art. 158.
249 Reg. 55 Rev., Art. 159.

enabling internal revenue officers to verify the fact that payment of the full amount of tax due thereon has been made.[250]

Subsequent Instrument Shall Indicate Prior Document to Which Stamps Are Affixed. Any policy of insurance or other instrument which is subsequent to or which confirms a contract of insurance that is created or evidenced by any prior instrument by which insurance was originally made or renewed, should bear a notation designating such prior instrument (hereinafter referred to as the original instrument) and showing that the proper stamps have been affixed thereto and cancelled. By this is meant that, if a letter, cablegram, or other instrument is so worded that it establishes or evidences a contractual relation between the insurer and the insured, executed or executory, by which insurance is made or renewed, or by which the relationship of insurer and insured is created or evidenced, such instrument shall be construed as the original instrument, and must have stamps of the proper amount affixed to it, and any policy or other instrument which is subsequent to or which confirms such original instrument must bear thereon the notation above indicated.[251]

Subsequent Instruments That Must Be Stamped. In case an instrument subsequent to the original instrument provides for the payment of a premium greater than the premium provided for in the original instrument, such subsequent instrument must have affixed thereto stamps equal to the tax imposed upon the additional premium charged therein; also such subsequent instrument must bear notation of the stamps affixed to the original instrument. The same rules apply to any riders, endorsements, or other forms attached to or forming a part of any original or subsequent instrument where such rider, endorsement, or other form provides for the payment of a premium greater than theretofore charged.[252]

Unstamped Instruments and Those Bearing No Notation of Stamping. Failure (a) to stamp the original instrument by which insurance is made or renewed, whether it be a letter of acceptance, cablegram, or other instrument by whatever name called, or (b) to indicate that such original instrument was properly stamped on any policy or other instrument which is subsequent to or which confirms the contract of insurance that is created or evidenced by any prior instrument by which insur-

250 Reg. 55 Rev., Art. 160.
251 Reg. 55 Rev., Art. 161.
252 Reg. 55 Rev., Art. 162.

ance was made or renewed, will be held to raise a presumption of an intent to evade the payment of tax.[253]

MEASURE OF TAX. The tax is measured by total premium paid, including any additional assessment or charge in the nature of a premium on each policy of insurance or other instrument by which insurance is made or renewed, and is at the rate of 3 cents on each dollar or fractional part thereof of such premium; for example, upon a premium charge of $10.10 the tax imposed is 33 cents, being 3 cents for each dollar and 3 cents for the fractional part of a dollar.[254]

INSURANCE ON COMMODITIES EXPORTED. No tax is imposed upon the premiums charged for insurance issued to cover commodities which are in the actual process of exportation and which have begun their voyage or preparation for the voyage from the United States. If a policy or other instrument is issued covering both export and non-export property, the tax will be computed upon the full amount of the premium charged, unless such instrument clearly indicates the property for export and the premium charged for the insurance thereon.[255]

MOVABLE PROPERTY. Movable property such as rolling stock of railroads, ships, vessels, barges, and other similar movable property, is held to be property within the United States if the principal place of business of the corporation or partnership, owning and controlling the same, is located within the United States, or in the case of an individual, if he resides in the United States, unless such property is permanently located without the United States for the purpose of ordinary use. The nation of registry of a vessel has no bearing upon the location of the property in the same.[256]

CREDITS AND REFUNDS. In case a policy of insurance or other instrument is issued and accepted by the insured, and afterwards, for any reason, such insurance does not become effective, the value of the stamps affixed thereto will be refunded upon a proper claim presented to the collector.[257]

PENALTIES. In addition to other penalties provided by the Revenue Act of 1921,[258] there is imposed a penalty of double the amount of the tax upon (a) any person to or for whom or in whose name any such policy or other instrument is issued, or (b)

[253] Reg. 55 Rev., Art. 163.
[254] Reg. 55 Rev., Art. 164.
[255] Reg. 55 Rev., Art. 165.
[256] Reg. 55 Rev., Art. 166.
[257] Reg. 55 Rev., Art. 167.
[258] § 1102.

any solicitor, agent, or broker acting for or on behalf of such person in the procurement of any such policy or other instrument, who fails to affix the proper stamps to such policy or other instrument, with intent to evade the tax.[259]

RETURNS. No monthly return or monthly statement showing a list of policies or other instruments by which insurance was made or renewed upon property located in the United States by a foreign corporation or partnership or non-resident individual is now required from any person to or for whom or in whose name such policy or other instrument is issued, or from the solicitor or broker acting directly or indirectly for or on behalf of such person, but each person, solicitor, or broker accepting, placing, or soliciting such policy or other instrument is required to keep a record of each policy or other instrument subject to the tax imposed by this subdivision by which he has directly or indirectly made, placed, solicited, or assisted in the making or renewal of, such insurance, or for which he has paid or received compensation, and shall be prepared to furnish full information to the Commissioner at any time upon demand.[260]

Leases. Leases are not taxed under this law.[261]

Mortgages. Mortgages are not taxed under this law.

Mutual Ditch and Irrigating Companies. Stocks and bonds issued by mutual ditch or irrigation companies are not taxable.[262] The law seems to exempt stock of such companies from the tax on the issue thereof,[263] and also from the tax on sales or transfers. The exemption does not extend to notes or any other instruments except certificates of stock and bonds.

Parcel-Post Packages. Parcel-post packages are not subject to stamp tax under the Revenue Act of 1921. For a discussion of the taxation thereof under the 1918 Law see the 1920 edition of this book.

Passage Tickets. The tax on passenger tickets is only imposed on tickets sold or issued in the United States for passage by any vessel to a port or place not in the United States, Canada or Mexico.[264] Such tickets are required to be stamped whether they are one-way or round-trip. No tax is imposed on tickets costing $10 or less. The rate is one dollar if the cost of the ticket does

259 Reg. 55 Rev., Art. 168; Revenue Act of 1921, Title XI, Schedule A-13.

260 Reg. 55 Rev., Art. 166.

261 Reg. 55, Art. 100.

262 Revenue Act of 1921, § 1101.

263 See Reg. 40 Rev., Art. 5.

264 Passage tickets sold or issued in the United States for passage by any vessel to a part or place in Newfoundland are subject to tax (Reg. 55 Rev., Art. 119).

not exceed $30; $3 if the cost of the ticket exceeds $30 and does not exceed $60, and $5 if the cost of the ticket exceeds $60.[265] Where a single ticket is issued for transportation for more than one passenger the ticket, coupon, or prepaid order must be stamped at the proper rate for each passenger based on the number of passengers, and the total amount paid for the transportation.[266] It is the duty of the person selling the ticket to affix the stamp to the ticket or paper which evidences the sale and cancel the stamp.[267]

TICKETS SUBJECT TO TAX. Passage tickets issued to private individuals traveling on vessel's operated privately or by any Government are taxable.[268] Passage tickets to Porto Rico or the Philippine Islands are taxable.[269] Passage tickets issued in the United States to ports not in the United States, Canada or Mexico on exchange orders purchased in Canada or Mexico in connection with through transportation from points in Canada or Mexico are subject to tax.[270] Passage tickets issued in the United States to ports not within the United States, Canada or Mexico on exchange orders purchased other than in the United States, Canada or Mexico, are subject to tax.[271]

TICKETS NOT SUBJECT TO TAX. Prepaid orders for passage tickets are not subject to tax.[272] Passage tickets issued to Hawaii or Alaska are not taxable.[273] Passage tickets sold in the United States from ports not within the United States, Canada or Mexico, to a port in the United States, Canada or Mexico, are not subject to tax unless sold as a part of a round trip or through ticket from a port in the United States, Canada or Mexico.[274]

PASSAGE TICKETS ISSUED TO FEDERAL AND STATE OFFICIALS AND FOREIGN REPRESENTATIVES. Passage tickets issued to United States Government officials, employees, military and naval forces. as well as officials of states and their political subdivisions, traveling in the course of their duty as such on vessels operated by private parties or by any government are not taxable when the amount of the passage is paid for by the United States Government, state or political subdivision thereof. Ambassa-

[265] Revenue Act of 1921, Title XI, Schedule A-9.
[266] T. D. 2067.
[267] T. D. 2067.
[268] Reg. 55 Rev., Art. 114.
[269] Reg. 55 Rev., Art. 115.
[270] Reg. 55 Rev., Art. 118.
[271] Reg. 55 Rev., Art. 119.
[272] Reg. 55 Rev., Art. 117.
[273] Reg. 55 Rev., Art. 116.
[274] Reg. 55 Rev., Art. 120.

dors, ministers and properly accredited diplomatic representatives of any foreign government to the United States are exempt from the payment of taxes on such passage tickets. All other foreign agencies not specifically mentioned above are subject to the tax.[275]

Playing Cards. A tax of 8 cents per pack is imposed upon every pack of playing cards containing not more than fifty-four cards, manufactured or imported, and sold or removed for consumption or sale. This rate became effective on April 1, 1919.[276] It has been held that the statute imposing a tax on playing cards requires that each pack of cards shall show a stamp denoting a payment of the tax, and a dealer, therefore, may not reassemble the cards from the packs on which the stamp tax has been paid and then offer the reassembled packs for sale in new wrappings without restamping.[277] Every manufacturer or importer of playing cards will be required to render a monthly report, under oath, on Form 749, in duplicate, showing the number of cards on hand at the first of the month, the number manufactured or received, likewise the number withdrawn, tax paid, or free of tax for export or use of the United States, and the number on hand at the end of the month, together with like information relative to the value of stamps received and used during the month. The report should be rendered on the last day of the month, or on or before the 10th day of the succeeding month. Blank returns, Form 749, may be procured from collectors.[278]

Powers of Attorney. Powers of attorney are taxable instruments under this law if they are such that they grant authority to do or perform some act for or in behalf of the grantor, which authority is not otherwise vested in the grantee. The tax attaches to or is imposed on the instrument itself and is not measured by the number of persons joining therein.[279] A power of attorney containing a power of substitution requires only one stamp.[280] Where the original power of attorney has been prop-

275 Reg. 55 Rev., Art. 113; Vol. 2, T. D. (1898), No. 20,196.

276 Revenue Act of 1918, Title XI, Schedule A-13; Revenue Act of 1921, Title XI, Schedule A-12. The Act of August 28, 1894, imposed a tax of 2 cents per pack on playing cards. The Act of October 3, 1917, imposed an additional tax of 5 cents per pack, or a total of 7 cents on each pack. The 1918 Law amended the former laws and provided a tax of 8 cents per pack, being the same rate as provided by the present law, as indicated in the text above. (T. D. 2817.)

277 U. S. v. Neustaedter, 149 Fed. 1010; Reg. 55 Rev., Art. 149.

278 T. D. 2817.

279 Revenue Act of 1921, Title XI, Schedule A-11. Reg. 55 Rev., Art. 130.

280 T. D. 2134.

erly stamped and a copy of it has been printed on a card (Form 272) provided by the Government, and the card is filed in the executive departments of the Government or with a collector, such copy is not subject to tax.[281] The rate of tax on powers of attorney is 25 cents. The law expressly provides that no stamps shall be required on any papers necessary to be used for the collection of claims from the United States or from any state for pensions, back pay, bounty or for property lost in the military and naval service.[282] Powers of attorney required in bankruptcy cases are also expressly exempted.[283] Powers of attorney contained in the application of those who become members of or policyholders in mutual insurance companies doing business on the inter-insurance or reciprocal indemnity plan through an attorney in fact, are declared by the law to be exempt.[284] The powers of attorney enumerated in the paragraphs immediately following are also exempt.

Warrant of Attorney in a Lease. A warrant of attorney, embodied in a lease is not taxable.[285]

Authorizing Federal Official to Sell United States Bonds in Case of Default. Powers of attorney given by persons who deposit United States Liberty bonds or other bonds of the United States as security in lieu of surety or sureties on penal bonds under the provisions of the Revenue Acts of 1918 and 1921, authorizing the official having authority to approve such penal bonds to collect or sell such United States bonds so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bonds, are not subject to the stamp tax.[286]

Authorizing Officer of Federal Reserve Bank to Assign United States Bonds Deposited as Security. A power of attorney executed by a bank authorizing a designated officer of a Federal Reserve Bank to assign United States bonds deposited with the Federal Reserve Bank and designed to protect it in event of default in payment of a loan is not taxable.

281 Reg. 55, Art. 145.

282 Revenue Act of 1921, Title XI, Schedule A-11.

283 This express exemption seems to have been introduced in the 1917 Law as a result of the decisions in the cases of In re Hawley, 220 Fed. 372, which held that a general letter of attorney in bankruptcy was taxable under the 1914 Law, and In re Capitol Trading Company, 229 Fed. 806, which held bankruptcy powers of attorney taxable under the 1914 Law.

284 Revenue Act of 1921, Title XI, Schedule A-11.

285 Reg. 55 Rev., Art. 141.

286 Reg. 55 Rev., Art. 147.

Powers of attorney given by persons who deposit United States Liberty bonds or other bonds of the United States as security in lieu of surety or sureties on penal bonds under the provisions of the Revenue Acts of 1918 and 1921[287] authorizing the officials having authority to approve such penal bonds to collect or sell such United States bonds so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bonds, are not subject to the stamp tax.[288]

AUTHORIZING DEPUTY TO HAVE ACCESS TO SAFE. A power of attorney authorizing a deputy to have access only to safe or safety deposit box is not subject to tax, but a power of attorney to have access and control over its contents is subject to tax.[289]

EXECUTED OR ACCEPTED IN FOREIGN COUNTRY. A power of attorney executed and mailed within the United States to a foreign point is subject to tax, but a power executed in a foreign country and mailed there to an agent in the United States is not subject to tax.[290]

FORMAL POWERS OF ATTORNEY. Powers of attorney which are merely formal and grant no authority which is not otherwise vested in the grantee are not taxable. Thus, it has been held that no tax is imposed upon powers of attorney in the following cases:

CONTAINED IN ASSIGNMENTS FOR VALUABLE CONSIDERATION, CONFERRING NO AUTHORITY UPON ASSIGNEE NOT IMPLIED BY THE ASSIGNMENT, NOT TAXABLE. An assignment, for a valuable consideration, of debts, wages, mortgages, bond, etc., ordinarily transfers to the assignee all the rights of the assignor and the remedies necessary for their enforcement, and the assignee acquires no further rights by the means of a power of attorney clause in the assignment than are conveyed by the instrument itself, and such pro forma power of attorney is therefore not taxable.[291]

ASSIGNMENT OF INSURANCE POLICIES. No stamp tax is imposed upon the power of attorney contained in a transfer by assignment, absolute or as collateral security, of an interest in a contract of insurance, if the power of attorney grants authority to do or perform only such acts for or in behalf of the assignor as are otherwise vested in the assignee.[292]

287 § 1320.
288 Reg. 55 Rev., Art. 147.
289 Reg. 55 Rev., Art. 146.
290 Reg. 55 Rev., Art. 142.
291 Reg. 55 Rev., Art. 137.
292 Reg. 55 Rev., Art. 134; T. D. 2599.

TO PAY POLL TAXES. Powers of attorney issued in accordance with the provisions of the state statutes authorizing a person to pay a poll tax of an individual are not required to be stamped.[293]

POWER OF SALE. The power of sale generally embodied in a mortgage, real or chattel, authorizing and empowering the mortgagee himself upon default to make a public sale of the property affected and to convey the title to the purchaser at such sale, free from all rights or equity of redemption, thus avoiding the necessity of resorting to the courts for foreclosure, differs from a power of attorney in many respects, one of which is that the latter always creates an agency or a representative relation, whereas a mortgagee under a power of sale acts on his own behalf and for his own benefit. Such power of sale is not taxable as a power of attorney.[294]

AUTHORITY TO SECRETARY OF CORPORATION TO TRANSFER STOCK. An instrument authorizing the secretary to transfer stock on the books of a corporation is not taxable as a power of attorney, but an instrument appointing an attorney in fact to transfer stock on the books of a corporation is taxable.[295]

PRO FORMA POWER OF ATTORNEY TO TRANSFER BONDS OR STOCKS ON BOOKS OF CORPORATION, PRINTED ON BOND OR STOCK CERTIFICATE. The pro forma power of attorney to transfer bonds or stocks on the books of a corporation, embodied in the assignment printed on the back of the bond or stock certificate, is not subject to tax.[296]

AUTHORIZING VENDEE OF SHARES OF STOCK TO TRANSFER SAME. A power of attorney by which a person executing the instrument sells, assigns and transfers shares of stock and appoints the vendee agent for the transfer is not subject to the tax.[297]

GRANTED BY CORPORATION. Where a corporation by resolution of its Board of Directors has empowered an officer thereof to sell, assign or transfer stock or bonds standing in the name of the corporation, or to perform any act in the name of the corporation, such authority is not taxable as a power of attorney for the reason that it is necessary for a corporation to perform its corporate acts through one of its officers. If, however, a person other than an officer of the corporation acting in his official capacity is given this authority, the power of attorney so granted is tax-

[293] T. D. 2269.
[294] Reg. 55 Rev., Art. 33; T. D. 2196.
[295] Reg. 55 Rev., Art. 138.
[296] Reg. 55 Rev., Art. 139; T. D. 2085; T. D. 2134.
[297] Reg. 55 Rev., Art. 144.

able.[298] A general power of attorney granted by a Board of Directors to a person other than an officer of a corporation acting in his official capacity for the purpose of representing the corporation in transactions of a like kind and nature, such as conveying land or acknowledging deeds, is considered by the Treasury Department as specific authority for each individual transaction, and a revenue stamp is required on each instrument executed under the power of attorney.[299]

JUDGMENT NOTES. Where judgment notes contain a clause authorizing any attorney at law to confess judgment in favor of the holder of the note, such authorization is held not taxable as a power of attorney. The instrument is held to be a warrant of attorney instead of a power of attorney.[300]

FROM CORPORATIONS TO RESIDENT AGENTS. Powers of attorney executed by corporations to resident agents authorizing the latter to accept service of process are taxable.[301]

TO SELL OR TRANSFER GOVERNMENT BONDS. A power of attorney to sell or transfer Government Bonds is taxable.[302]

TO SELL, ETC., SHARES OF CAPITAL STOCK. A power of attorney to sell, assign and transfer shares of capital stock is subject to tax unless it is given in connection with a deposit of the stock as security for a loan.[303]

WHEN TAX ACCRUES. The tax on a power of attorney is due when the instrument is executed and delivered, and not when the power is exercised.[304] Delivery includes depositing the instrument in the mails. Powers of attorney executed and delivered prior to April 1, 1919, are not taxable even though used subsequent to that date, except such as are taxable under the 1917 Law.[305]

Produce, Sales of, on Exchange. The tax is imposed upon (a) sales of, (b) agreements of sale, and (c) agreements to sell[306]

[298] Reg. 55 Rev., Art. 131.
[299] Reg. 55 Rev., Art. 132.
[300] Treat v. Tolman, 113 Fed. 892; Reg. 55 Rev., Art. 140; T. D. 2081.
[301] Reg. 55 Rev., Art. 135.
[302] Reg. 55 Rev., Art. 136.
[303] Reg. 55 Rev., Art. 143.
[304] Reg. 55 Rev., Art. 129; T. D. 2134.
[305] Reg. 55 Rev., Art. 148.
[306] See Treat v. White, 181 U. S. 264, and note 62. The term "sale" or "contract of sale" includes all sales, or agreements of sale, or agreements to sell, including so-called transfers or "scratch sales"; the term "agreement of sale," or "agreement to sell," includes options, calls in "puts and calls," offers, indemnities, and privileges. (Reg. 40 Rev., Art. 33.)

for future delivery[307] any product or merchandise at or under the rules or usages of[308] any Exchange or Board of Trade, or other similar place.[309] In a case arising under the 1914 Law it was held that offers to sell grain made subject to deferred acceptance, only a small percentage of which developed into sales and on which the brokers received only $10 for each ten thousand bushels sold, were taxable on the basis of the total price on which the seller agreed to sell rather than the basis of what the buyer was to receive; and also that the tax was imposed on each sale or agreement to sell any grain, though during the day several distinct and separate sales were made of the same grain and at the close of the day the only memoranda made showed a transfer from the original seller to the last buyer.[310] So-called transferred or scratch-sales are no longer taxed, being expressly stated not to be included.[311] Neither are pass-outs subject to tax.[312] No bill, memorandum, agreement or other evidence of a sale, or agreement of sale, or agreement to sell, in case of cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered are subject to this tax. When the seller of commodities subject to this tax has paid the tax, he may transfer his contracts to a clearing house without paying a tax on such transfer if the transfer does not vest any beneficial interest in such clearing house association, but is made for the sole purpose of enabling the clearing house association to adjust and balance the accounts of its members on their several contracts. The

307 The act of October 22, 1914, provided for a tax on agreements either for present or future delivery but made an express exemption to cover cases where products or merchandise were actually delivered at the time of sale or were in vessel, boat or car and actually in the course of transportation.

308 The words "or under the rules or usages of" were added by the Revenue Act of 1918, Title XI, Schedule A-5.

309 Revenue Act of 1921, Title XI, Schedule A-4; Reg. 40 Rev., Art. 22.

310 Calkins v. Smietanka, 240 Fed. 138.

311 Reg. 40 Rev., Art. 23. So-called transferred or scratch sales were expressly included in the 1917 Law (Act of October 3, 1917, § 807, Schedule A-5). They were not mentioned expressly in the 1914 Law. The term "transferred or scratch sale" includes "pass-outs" or those transactions in which a person buys from another a certain quantity of any product, at a certain price, and at the same session of an exchange, sells to a third person the same quantity of the same product at the same price, and eliminates himself by instructing the person from whom he bought to deliver such product to the person to whom he sold; but no transaction in which a broker or a commission member of an exchange receives a commission greater than that charged to a person who executes his own contracts shall be deemed to be a "transfer" (or a "scratch sale".) (Reg. 40 Rev., Art. 33.)

312 Reg. 40 Rev., Art. 23.

rate is as follows: 2 cents for each $100 or fraction thereof in value of the merchandise covered by the sale or agreement of sale or agreement to sell.[313] It is provided by the Revenue Act of 1921 that the above provisions taxing sales of produce shall not affect but shall be in addition to the provisions of the "United States Cotton Futures Act," approved August 11, 1916, as amended, and "The Future Trading Act," approved August 24, 1921.[314]

WHEN TAX ACCRUES. The stamp tax on sales of products and merchandise for future delivery accrues immediately upon the making of the sale, agreement of sale, or agreement to sell, and is in no wise dependent upon the manner of delivery of the product.[315]

IMMEDIATE OR PROMPT DELIVERY. Cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered are not taxable.[316] "Immediate or prompt delivery" is held to mean delivery at once or as soon as practicable, and in any event within twenty days from the date of sale or agreement of sale or agreement to sell.[317] Every sale or agreement not evidenced by a memorandum or contract expressly requiring immediate or prompt delivery within the above definition is deemed to be for future delivery. In all cases in which the Commissioner is not satisfied from the evidence submitted to him that the transaction was in good faith intended to be followed by immediate or prompt delivery, within the above definition, the seller will be required to pay the tax as on a sale for future delivery.[318]

EXCHANGE OR BOARD OF TRADE. The law taxes only sales at or under the rules or usages of an exchange or board of trade or other similar place.[319] The term "exchange," except where it is plain from the context that a different meaning is intended, includes each and every agency, board of trade, bourse, auction place, or other meeting place, whether under shelter or in the open, at which products or merchandise are publicly bought, sold, bid for, offered, or exchanged, for future delivery, or contracts for such future delivery are made, either between members of such exchange, or between members and non-members,

313 Revenue Act of 1921, Title XI, Schedule A-4; Reg. 40 Rev., Art. 21.

314 Revenue Act of 1921, Title XI, Schedule A-4.

315 Reg. 40 Rev., Art. 20.

316 Revenue Act of 1921, Title XI, Schedule A-4; Reg. 40 Rev., Art. 22

317 Reg. 40 Rev., Art. 33.

318 Reg. 40 Rev., Art. 22; Reg. No. 40, Part II, Art. 4.

319 Revenue Act of 1921, Title XI, Schedule A-4.

patrons, and the public; and includes places at which there is only one manager or firm, who controls all the sales and purchases at that particular place or where no actual delivery of the products or merchandise is contemplated, and all incorporated and unincorporated associations of individuals, partnerships, and corporations engaged in the business of publicly selling, buying, or exchanging products or merchandise for future delivery.[320]

TRANSFERS TO CLEARING HOUSE. Sellers of products, merchandise or commodities having paid the tax provided by law may transfer such contracts to a clearing house association, and such transfer is not taxable within the provisions of the Act, provided that the transfer does not vest any beneficial interest in the clearing house association and is made for the sole purpose of enabling such clearing house association to adjust and

[320] Reg. 40 Rev., Art. 33. Reg. No. 40, Part 2, Art. 1. For a detailed consideration of the nature of an exchange or board of trade, see the case of Nicol v. Ames, 173 U. S. 509. This case went so far as to hold the Union Stock Yards to be a "similar place" within the meaning of the 1898 Law. No sales or purchases of stocks were made by members of the Union Stock Yards Company as such. Anyone was accorded the right to bring his cattle to the stock yards upon payment of the regular fees and compliance with the regulations made by the company, and, having brought his cattle, he had the right accorded him by the company to have them kept, fed, watered, etc., and to sell them himself or by a commission merchant, who did not need to be a member of the Stock Yards Company. The court said: "It is plain to be seen that the privilege or facility for a sale of the cattle or other stock at the yards of such company is of precisely the same nature and character as that which exists at an exchange or board of trade which is so described in terms. That the sales are made by the owners of the cattle or by commission merchants who are not members of the stock-yards company, is not material. The facilities for a sale exist and are made use of in each case, and are in truth the same in each. A perusal of the facts contained in the record in the case shows that those yards answer all the purposes of an exchange or board or trade, and that they in truth amount in substance to the same thing. The differences existing between them are unsubstantial so far as this point is concerned. The sales at that place are accomplished with a facility which it is plain could not exist but for the conditions and advantages afforded by the use of those yards. The owner of the cattle who brings them to the yards and avails himself of the privilege of selling them at that place does without doubt make use of a privilege which everyone knows is an advantage sufficient to constitute a material difference between a sale at the yards and a sale elsewhere. This advantage, although one which any person could use, is yet of precisely the same nature as that existing in the case of an exchange or board of trade, and it is therefore a similar place within the meaning of the statute. Being a similar place, the reasons stated in the foregoing cases apply with equal force here and demand the same judgment."

balance the accounts of its members on their several contracts.[321] A clearing house is defined to be any incorporated or unincorporated association or committee carried on for the purpose of clearing, settling and adjusting transactions in purchasing, selling or delivering products or merchandise, whether such clearing house be a part or department of an exchange or an independent body.[322]

INCONSISTENT BY-LAWS, RULES OR CUSTOMS OF EXCHANGE. No provisions, by-laws, rules, or customs of any exchange, board of trade, or similar institution or place of business which are inconsistent or in conflict with any requirement or provision of the law, or any regulations made thereunder, or any collateral, or additional agreement, verbal or written, respecting the subject-matter of such contract or the settlement or fulfillment thereof which is inconsistent or in conflict with any requirement of said act or regulations, will exempt any person from the payment of tax on sales of produce on an exchange.[323]

SALE OF STAMPS. The ruling of the Treasury Department in regard to the sale of stamps to be attached to sales, agreements of sale, or agreements to sell products or merchandise is given elsewhere in this book.[324]

REGISTRATION AND RECORDS. All persons engaged in the business of making contracts of sale on any exchange and all clearing houses and members of exchanges are required to register and keep records of transactions subject to the tax. The rulings in this respect are referred to more fully in a subsequent part of this chapter.[325]

Promissory Notes. The law provides that the tax on promissory notes, and for each renewal of the same, for a sum not exceeding $100 shall be 2 cents; and for each additional $100 or fractional part thereof 2 cents. Drafts or checks expressly payable otherwise than at sight or on demand are also taxable at the same rate.[326]

The stamp tax on a promissory note is measured by the amount of the principal obligation without regard to the form in which the obligation to pay interest is expressed.[327]

321 Revenue Act of 1921, Title XI, Schedule A-4; Reg. 40 Rev., Art. 23.

322 Reg. 40 Rev., Art. 33; Reg. No. 40, Part II, Arts. 1-4.

323 Reg. 40, Art. 24.

324 See p. 1238.

325 See p. 1231.

326 Revenue Act of 1921, Title XI, Schedule A-5; Reg. 55, Art. 63.

327 Reg. 55 Rev., Art. 48 (b).

WHO AFFIXES STAMP. The person who makes or issues a promissory note is required by the law to place the stamp upon the same and cancel it. If he does not do so the holder or owner may affix and cancel the stamp as agent for the maker. The drawee, payee or endorsee should see that the tax is paid before or at the time of acceptance or delivery.[328] The question of who shall pay for the stamp is a matter of adjustment between the parties.[329] If a draft is presented to the drawee for acceptance and discount by him, stamps must be first affixed by the drawer, for the acceptance and delivery are simultaneous. The payee or the indorsee from the drawer must see to it that the drawer, as the person "who makes, signs or issues" the draft, pays the tax before delivery. "Accept" is used in the penal provision in Section 1102 in the general sense of "receive," not in the special sense peculiar to drafts. No drawee accepting an unstamped, undelivered draft would violate the law; but if the draft has already become taxable because of a prior delivery, the acceptor must be sure that stamps are affixed.[330]

RENEWAL OF NOTES. A renewal after the incidence of the tax of a note issued prior thereto is subject to tax.[331] Any writing or instrument however designated which operates as a renewal of a promissory note is taxable.[332] A written agreement, either attached or unattached to a promissory note or in the form of an endorsement on the note, such as "renewed" or "extended" to a certain date, evidencing payment and acceptance of interest in advance to a time certain, subsequent to maturity, constitutes a renewal of the note and is subject to tax as such.[333] Mere suspension of payment or forbearance is not taxable.[334] Part payment of a note after it becomes due, or payment of accrued interest after maturity, the note being allowed to run and the holder neither losing nor postponing his right of action, is merely in the

[328] Reg. 55 Rev., Art. 48.

[329] Reg. 55, Art. 35.

[330] T. D. 2682.

[331] Revenue Act of 1921, Title XI, Schedule A-5. Letter from treasury department dated December 11, 1917; W. T. S. 1918, ¶ 3679.

[332] Reg. 55 Rev., Art. 51.

[333] Reg. 55 Rev., Art. 60. The following endorsement will operate under this rule as a renewal: "19—. Received six months interest to ———, 19—, $———."

The stamps should be affixed to the extension agreement and not to the original note (letter from treasury department dated March 31, 1921; W. T. S. 1921, ¶ 4027).

[334] Reg. 55 Rev., Art. 57.

nature of a forbearance and is not taxable as a renewal.[335] A contract or agreement extending either a chattel or real estate mortgage is not taxable, but if such extension effects the renewal of promissory notes, either embodied in the mortgage or given in connection with the mortgage, the renewal of such notes is taxable.[336]

TRANSFER OF NOTES. No stamp is required upon the transfer by indorsement of promissory notes.

DEFINITION OF PROMISSORY NOTES. A promissory note is an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand or at a fixed or determinable future time, a sum certain in money to such other person or to order or to bearer, free from restrictions as to registration or transfer, and usually without coupons.[337] The term "promissory notes," as used in the statute includes those payable on demand.[338] Promissory notes given for security only are taxable.[339] Whether or not an instrument is taxable as a promissory note depends upon its form and not upon its use. Thus, a receipt given by a loan company for property received as security for a debt is not a promissory note; but, if in the receipt there is included a promise to pay a certain sum of money at a specified time, with interest, for value received, such a provision in the opinion of the Treasury Department is a valid promissory note, upon which the maker would be liable in a suit at law, and is taxable.[340] Policy loan and premium extension agreements which contain an unqualified promise to pay a specified sum of money at a certain date are subject to stamp tax as promissory notes. Where the sole remedy of payee in case of nonpayment of the premiums or loans is to reduce or cancel the rights of the insured, tax does not accrue.[341] In the case of contracts for the purchase of pianos, machinery, and other merchandise, there is sometimes included, among other conditions and provisions, an agreement to pay the vendor a stipulated sum of money at a certain time, with interest, for value received. If this agreement is in form and effect a good and valid promissory note, upon which the maker would be liable in a suit at law, such promissory note is taxable. If, how-

[335] Reg. 55 Rev., Art. 59. Letter from treasury department dated June 14, 1918; W. T. S. 1918, ¶ 3742. See T. D. 2265.

[336] Reg. 55 Rev., Art. 52; T. D. 2170.

[337] Reg. 55 Rev., Art. 48.

[338] Reg. 55 Rev., Art. 49.

[339] Reg. 55 Rev., Art. 50.

[340] T. D. 2170.

[341] Reg. 55 Rev., Art 61; T. D. 2599.

ever, the contract merely provides for the payment of the purchase price in installments and enumerates the dates upon which such payments are due, stating, as many of the contracts do, that in default of payment the vendor may take the property, such agreement is not a promissory note.[342] It is often difficult to make a distinction between promissory notes and bonds of indebtedness. Although in a broad sense many notes are bonds and many bonds are notes, obviously Congress did not intend to tax the same instrument under two heads.[343] An instrument, not under seal, containing a simple promise to pay a sum of money at a specified time, such as is common in everyday commercial use, is a promissory note.[344] It has been held, however, that the fact that a promissory note is under seal does not make it taxable as a bond.[345] A short term instrument, although issued by a corporation under a trust indenture, may be regarded as a note if every instrument of such issue both (a) is payable to bearer and incapable of registration and (b) lacks interest coupons, and so requires presentation upon each payment of interest.[346] Thus, the fact that a note may be secured by a mortgage or issued under a deed of trust does not necessarily make it taxable as a bond. One distinction between bonds and promissory notes seems to be the time for which the note or bond is to run. Promises to pay within a comparatively short period of time, such as one year or two years, are usually held to be taxable as notes while promises to pay at the end of a longer period are considered more in the nature of bonds or certificates of indebtedness.

Coupons attached to bonds, debentures, or certificates of indebtedness issued by any individual, partnership, or corporation, or to instruments, however termed, issued by a corporation and known generally as corporate securities (all of which are subject to tax as bonds of indebtedness) are not subject to tax if they impose no obligations not imposed by the principal instrument. Interest coupons attached to promissory notes, as distinguished from the securities enumerated above, if they are themselves promissory notes, separable from the principal obligation and negotiable independently of it, are subject to tax, even though

[342] T. D. 2170.

[343] T. D. 2713. See Paragraph on Bonds of Indebtedness.

[344] T. D. 2713. See Paragraph on Bonds Given in Penal Sum.

[345] T. D. 21815. (Act of June 13, 1898.)

[346] T. D. 2713.

they impose no obligation not imposed by the principal instrument.[347]

CHECKS OR DRAFTS PAYABLE OTHERWISE THAN AT SIGHT OR ON DEMAND. The liability of an instrument to stamp tax, as well as the amount of such tax, is determined by the form and face of the instrument, and cannot be effected by proof of facts outside of the instrument itself.[348] Unless the statute expressly so provides, drafts, acceptances, overdrafts, and postdated checks are not taxable as promissory notes, even though they perform some of the functions of a promissory note. It is no doubt in view of the decision above quoted that drafts and checks payable otherwise than at sight or on demand are by the present law expressly included in the same category as promissory notes. The general rule is that a draft or check delivered within the United States is subject to the tax *if expressed* to be payable otherwise than at sight or on demand.[349] So-called trade acceptances are taxable in the same manner as ordinary time drafts.[350] Drafts directly against an actual shipment are taxable in the same manner as other domestic time drafts.[351] Drafts drawn at sight or on demand with a notation thereon to "hold for arrival of goods," or payable "on arrival of car," or words of like effect, are taxable as drafts drawn otherwise than at sight or on demand.[352] Any notation appearing on such drafts, or on a bill of lading or other papers accompanying same, including collection letter, which defers the time of payment, renders the draft taxable.[353] But a sight draft accompanied by instructions outside the instrument, as "Do not present until arrival of car"

[347] Reg. 55 Rev., Art. 58. T. D. 2101. Kenosha v. Lamson, 9 Wall 477; Lexington v. Butler, 14 Wall. 282.

[348] U. S. v. Isham, 17 Wall. 496. Reg. 55 Rev., Art. 37. In Granby Co. v. Webster, 98 Fed. 604, decided under the 1898 Law, the court, following U. S. v. Isham (supra) explains the rule as follows: "Were it necessary to inquire into all the circumstances attending the execution of an order for the payment of money, before it can be ascertained whether it be liable to the stamp tax, endless delay would be occasioned. The purpose of the tax —the prompt relief of the treasury—would be defeated." Under the 1914 Law it was held that in view of the decision in U. S. v. Isham, drafts, acceptances, overdrafts, and post-dated checks were not taxable as promissory notes, even though they were used in such a way as to perform some of the functions of a promissory note. (T. D. 2170.)

[349] Reg. 55 Rev., Art. 63; T. D. 2682.

[350] Reg. 55 Rev., Art. 39.

[351] Reg. 55 Rev., Art. 40.

[352] Reg. 55 Rev., Art. 37.

[353] Letter from treasury department dated February 20, 1918; W. T. S. 1919, ¶ 3698. T. D. 2682.

or some such memorandum, is not taxable.[354] And a sight draft accepted and paid by the collecting bank for the drawee, which holds it and charges interest until the drawee takes it up, is not taxable.[355] A draft might be drawn stating no time for payment, which would class it as a sight draft, and be accepted at ninety days, which would change its nature.[356] If negotiated or delivered before acceptance the holder would be obliged to stamp it on acceptance, in default of which both he and the acceptor would be liable for the statutory penalty.[357] For the purposes of the tax there is no difference in the treatment of ordinary bills of exchange, trade acceptances, and bankers' acceptances, as defined by the regulations of the Federal Reserve Board.[358] The general rule is that a taxable draft or check becomes subject to tax concurrently with its delivery or acceptance.[359] In case of a draft the rule means that the tax attaches, not when it is signed by the drawer, or presented to the drawee for acceptance, but when it is delivered to or accepted by the payee, if drawn to a third person, or negotiated by the drawer, if drawn to his order. If a draft was drawn before the passage of the law, but not delivered, accepted, or negotiated until afterward, the tax is payable.[360]

Drafts Drawn Against Exports. In view of the constitutional prohibition against a restriction of, or any tax on, exports, drafts with bills of lading attached covering goods in the course of exportation or drafts drawn in this country directly covering exports to foreign countries and which constitute an inherent, *bona fide* and necessary part of the process of exportation are exempt from the stamp tax.[361] This exemption does not depend on whether or not the time which the draft has to run will expire before or after the ocean shipment.

Where the exporter draws a time draft upon the buyer abroad for the sale price of the merchandise and presents this draft, accompanied by the shipping documents, to his bank for discount,

354 Reg. 55 Rev., Art. 37; T. D. 2682.

355 T. D. 2682.

356 Reg. 55 Rev., Art. 38.

357 T. D. 2682.

358 T. D. 2682.

359 Reg. 55 Rev., Art. 34.

360 T. D. 2682.

361 Reg. 55 Rev., Art. 41; T. D. 2682; letter from treasury department dated April 13, 1918; W. T. S. 1919, ¶ 3711. Letter from treasury department dated January 24, 1918; W. T. S. 1919, ¶ 3710. See U. S. v. Hvoslef, 237 U. S. 1. Compare with Simpson v. Treat, 126 Fed. 1003. See paragraph on the Constitutionality of Stamp Taxes, p. 1245.

the draft is not subject to stamp tax. It sometimes happens that the exporter is unable to negotiate a draft drawn by him in the manner above set forth and, so that he may receive the full value for the same, he may be able to obtain a loan or advance in some form from his bank which will take the draft in question for collection. In such case the exporter may give his note to the bank secured by the draft, or instead of borrowing money from the bank and giving his note therefor, he may draw a second draft payable at a future date upon his bank, payment for which second draft is to be liquidated by the payment of the draft drawn upon the foreign buyer. Methods of financing similar to those outlined above are used in connection with exportations of merchandise where the original documents forwarded abroad are not accompanied by drafts upon the buyers, but are either forwarded against sales previously made or on consignment to be sold either on arrival or to await better market conditions. The exporter either borrows money from his bank and gives his note, or draws his draft upon his bank payable at a future date, with the understanding that the proceeds of the sale of the merchandise are paid into the collecting bank abroad for the account of the bank making the loan or discounting the draft of the exporter in the United States, such proceeds from time to time to be used in liquidating such loan or advance. It has been held that the drafts and notes, including renewals thereof, employed in transactions such as above outlined do not directly cover exports to a foreign country and do not constitute an inherent, necessary and *bona fide* part of the actual process of exportation and are, therefore, subject to stamp tax.[362] Where a taxpayer sold and shipped goods to a Cuban firm in Cuba on open account and the Cuban firm, after making a small cash payment, offered to give its acceptance for the balance due on account of goods shipped it has been held that this draft, which is not accompanied by shipping documents, is subject to stamp tax.[363]

Time drafts drawn against the proceeds of a draft against exports are taxable. A time draft drawn on a domestic bank for the purpose of securing money to purchase goods to be exported is subject to tax regardless of the fact that a contract for the sale of the goods existed at the time the draft is drawn.[364]

[362] Letter from treasury department dated September 21, 1920; W. T. S. 1921, ¶ 3792.

[363] Letter from treasury department dated November 4, 1921; W. T. S. 1921, ¶ 4065.

[364] Reg. 55 Rev., Art. 42.

A time draft directly covering a sale for export to a foreign buyer and drawn on a domestic bank as the authorized acceptor of the foreign buyer is exempt from stamp tax. A time draft drawn by or on an exporter or on his bank in payment for export shipments made by the manufacturer on the exporter's order is subject to stamp tax.[365] Time drafts not covering exports drawn and delivered or accepted in the United States and payable in foreign countries are taxable.[366] A draft drawn against a foreign steamship company covering a bill for bunker coal furnished in this country is taxable since such a sale of coal is held to be a domestic sale and not an export.[367] Stamp tax attaches to time drafts covering articles shipped from the United States, Hawaii, and Alaska to Canal Zone, if the drafts are delivered within the United States, Hawaii, or Alaska.[368] Stamp tax does not attach to time drafts covering shipments to the Virgin Islands, Philippines, and Porto Rico, because of express legislation exempting shipments to these dependencies.[369]

TIME DRAFTS COVERING SHIPMENTS FROM VIRGIN ISLANDS, PHILIPPINES AND PORTO RICO. Time drafts drawn against shipments from the Virgin Islands, the Philippines, and Porto Rico, into the United States, are subject to stamp tax if delivery or acceptance of said drafts first takes place within the United States, Alaska, or Hawaii.[370]

DRAFTS DELIVERED IN FOREIGN COUNTRIES. The general rule is that a taxable draft or check becomes subject to the tax concurrently with its acceptance or delivery within the territorial jurisdiction of the United States (including the states, the District of Columbia, Hawaii, and Alaska), whichever is prior. The rule means that the tax does not attach to a draft drawn here, but delivered and accepted abroad, but does attach to a draft drawn abroad and delivered or accepted here.[371] Where drafts are drawn outside the United States and acceptance or delivery made within the United States but payable in terms of foreign currency, the stamp tax should be computed at the rate of exchange at the time and place of such delivery or acceptance.[372]

[365] Reg. 55 Rev., Art 43.

[366] Reg. 55 Rev., Art. 44.

[367] O. D. 87: Ruling No. 202, March, 1921; W. T. S. 1921, ¶ 4034.

[368] Reg. 55 Rev., Art. 45.

[369] Reg. 55 Rev., Art. 46.

[370] Reg. 55 Rev., Art. 47.

[371] Reg. 55 Rev., Art. 34. Telegram from treasury department dated April 14, 1919; W. T. S. 1919, ¶ 3769.

[372] Letter from treasury department dated September 20, 1921; W. T. S. 1921, ¶ 4064.

In general, a draft sent through the mail is delivered when and where deposited in the mail addressed to the payee or the indorsee from the drawer.[373] If a draft drawn abroad, on a foreign drawee, with a foreign payee, passes through a bank here in the course of collection, no tax is payable unless it should be delivered by an agent of the drawer to an agent of the payee within the United States.[374]

NOTES DRAWN IN FOREIGN COUNTRIES. A promissory note drawn in a foreign country, and placed in the mails in that country for delivery to a person residing in the United States, is not required to be stamped. Delivery of commercial paper is necessary for its completion and by the weight of authority such an instrument is delivered when placed in the mails. The laws of the foreign country, therefore, would determine the validity of the contract, even if the instrument is made payable in the United States. On the other hand, a promissory note drawn in the United States and placed in the mails for delivery to a person residing in a foreign country is taxable, for the reason above stated.[375]

NOTES SECURED BY PLEDGE OF UNITED STATES SECURITIES. No stamp tax is required or imposed upon a promissory note secured by the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is secured by the pledge of such bonds or obligations, provided, that in either case the par value of such bonds or obligations does not exceed the amount of such note.[376] The bonds mentioned include Liberty Bonds as well as other United States bonds and printed obligations.[377] The Treasury Department has ruled that promissory notes secured by certificates of indebtedness issued by the Director General of Railroads

[373] Revenue Act of 1921, Title XI, Schedule A-5, contains the expression "upon their acceptance or delivery within the United States, whichever is prior." The 1917 Law was silent in this respect. See Reg. 55 Rev., Arts 33, 34, modifying T. D. 2682.

[374] Reg. 55 Rev., Art. 36; T. D. 2682.

[375] Reg. 55 Rev., Arts. 64, 65; T. D. 2170. See also T. D. 2682.

[376] Revenue Act of 1921, Title XI, Schedule A-5. This provision is now expressly included in the Stamp Tax Act, its substance having formerly been contained in T. D. 2701, based upon the War Finance Corporation Act, Title 3, 301.

[377] T. D. 2701. War Finance Corporation Act, Title 3, 301; Revenue Act of 1921, Title XI, Schedule A-5.

are exempt from stamp tax;[378] and that promissory notes secured by bonds of the War Finance Corporation are subject to tax.[379]

NOTES ISSUED BY GOVERNMENT. The law provides that no bond, note or other instrument issued by the United States or by any foreign government or by any state, territory, or the District of Columbia or local subdivision thereof, or municipal or other corporation exercising the taxing power, shall be subject to tax.[380] Bank notes issued for circulation are also expressly exempted from the tax.[381]

Promissory notes given to Federal land banks and joint-stock land banks when secured by first mortgages, and promissory notes issued by Federal land banks are exempt from stamp tax. Promissory notes issued by joint-stock land banks are subject to stamp tax.[382]

Promissory notes issued by the Food Administration Grain Corporation are subject to stamp tax.[383]

Proxies. The tax is imposed on every proxy for voting at any election of officers[384] or for voting at any meeting for the transaction of business of any corporation. The term "corporation" is defined to include associations, joint-stock companies and

[378] Reg. 55 Rev., Art. 56; letter from treasury department dated May 10, 1919; W. T. S. 1919, ¶ 3776.

[379] This ruling seems contrary to the purpose of the statute. The exemption referred to at beginning of the above paragraph was taken from the War Finance Corporation Act, as stated in note 376, and seems to have been intended to apply to War Finance Corporation bonds. In this connection the following definition of the term "obligation or other security of the United States," from R. S. 5414, referring to offenses against the currency, etc. "The words 'obligation or other security of the United States' shall be held to mean all bonds, certificates of indebtedness, national-bank currency, coupons, United States notes, treasury notes, gold certificates, silver certificates, fractional notes, certificates of deposit, bills, checks or drafts for money, drawn by or upon authorized officers of the United States, stamps and other representatives of value, of whatever denomination, which have been or may be issued under any Act of Congress," is interesting and seems broad enough to include War Finance Corporation Bonds. There seems to be no valid distinction between certificates of indebtedness issued by the director general of railroads and War Finance Corporation Bonds for purposes of this exemption.

[380] Revenue Act 1921, § 1101; Reg. 55 Rev., Art. 54.

[381] Revenue Act of 1921, Title XI, Schedule A-5.

[382] Reg. 55 Rev., Art. 53.

[383] Telegram from treasury department dated April 14, 1919; W. T. S. 1919, ¶ 3768. Telegram from treasury department dated April 10, 1919; W. T. S. 1921, ¶ 3819.

[384] Directors of a corporation are officers within the meaning of the clause imposing a tax on proxies for voting at the election for officers of an incorporated company. (Reg. 55, Art. 123.)

insurance companies.[385] Under the 1914 Law the tax was only on proxies for voting at any election of officers. The present law, as well as the 1917 and 1918 Laws, taxes all proxies used at meetings for the transaction of business. The tax is 10 cents on each proxy. A proxy for voting at any election for officers of a corporation and authorizing the proxy to act in such capacity upon all questions or matters presented at a stockholders' meeting, is subject to tax of 10 cents only.[386] Proxies for voting at any election of officers, or meeting for the transaction of business of any religious, educational, charitable, fraternal, or literary societies, or public cemeteries, are expressly exempt.[387] Proxies for the purpose of voting the stock of building and loan associations are taxable.[388]

PROXIES SIGNED BY TWO OR MORE STOCKHOLDERS. The stamp tax on proxies attaches to the instrument and is not measured by the number of grantors and grantees.[389] A power of substitution contained in a proxy would seem not to be taxable either on the ground that it is a proxy or on the ground that it is a power of attorney.

WHEN TAX ACCRUES. It seems that the proxy need not be stamped until it is accepted by the person to whom it is issued, but must be stamped before it can be used. Thus, it has been held that a power of attorney or proxy executed by a person residing in a foreign country to a person residing in this country is taxable, as the instrument is not operative and effective until accepted by the person in this country to whom it is issued. Powers of attorney and proxies executed by a person residing in the United States to a person in a foreign country are not taxable.[390] Powers of attorney or proxies executed and accepted before the incidence of the tax are not taxable, even though used after the incidence of the tax.[391]

WHO MAY AFFIX STAMPS. Where proxies are sent out by corporations to be executed and returned to the corporation or to the person named in the proxy, such proxies may be stamped after execution and delivery by the person receiving the same as the agent of the person executing the proxy.[392] The stamp

[385] Reg. 55, Arts. 126-127.
[386] Reg. 55 Rev., Art. 126.
[387] Revenue Act of 1921, Title XI, Schedule A-11.
[388] Reg. 55 Rev., Art. 124.
[389] Reg. 55 Rev., Art. 121, modifying T. D. 2129.
[390] T. D. 2129.
[391] Reg. 55 Rev., Art. 125.
[392] Reg. 55 Rev., Art. 128; T. D. 2067.

may be affixed and cancelled either by the party who executes the proxy or by the party to whom the proxy is given.[393] Where the stamp is affixed by an officer or employee of the corporation it is sufficient to cancel the stamp by writing thereon the initials of the officer or employee or the initials of the corporation and by incision or perforation if the stamp has a value of 10 cents or more.[394]

Rights to Receive Stock Dividends. Such rights are taxable as certificates of profits.[395] See Capital Stock, Sales and Transfers above.

Rights to Subscribe for Stock. Under the present law, rights to subscribe for stock or to receive shares or certificates of stock (or of profits or interest in property or accumulations) in any corporation are expressly made subject to tax.[396] See Capital Stock, Sales and Transfers above.

Security Agreements and Applications for Loans. Neither a security agreement signed by a prospective borrower of a bank, empowering the bank to apply any securities, money, or other property of the prospective borrower in the hands of the bank to satisfy the debt of the borrower to the bank, nor the form of application for the loan, is included in the classes of instruments made subject to stamp tax under Schedule A of Section 1107, and neither is therefore subject to such tax.[397]

Voting Trust Certificates. The issue of voting trust certificates is not subject to the stamp tax[398] but the transfer of such certificates is subject to the tax.[399] See Capital Stock; Issue, and Capital Stock; Sales and Transfers; above.

Records Required in Case of Sales and Transfers of Stock. The following ruling was made under the 1918 Law: Every person who makes an agreement to sell or transfer title to shares of stock by delivery of certificates assigned in blank, shall as a part of such transaction promptly make and deliver to the buyer a bill or memorandum of such sale or agreement to sell, duly signed by the seller or his agent, to which the requisite stamps shall be affixed and canceled, which bill or memorandum shall show the date of the transaction, the names of the seller and buyer and the name and number of shares of stock, and the

[393] Reg. 55 Rev., Art. 122; T. D. 2129.
[394] Letter from treasury department dated January 8, 1915.
[395] Reg. 40 Rev., Art. 12.
[396] Revenue Act of 1921, Title XI, Schedule A-3; Reg. 40 Rev., Art. 12.
[397] See T. D. 2599.
[398] Reg. 40 Rev., Art. 5.
[399] Reg. 40 Rev., Art. 12.

price per share and the tax paid thereon, and in the case of a transaction made on an exchange shall bear a number upon the face thereof and have printed and written in ink thereon the words "Subject to the Revenue Act of 1918 and regulations made in accordance therewith." No more than one such bill or memorandum made by the seller on any given date shall bear the same number: Provided, however, that no single transaction or purchase or sale that is made upon an exchange by one member to another member shall require to be evidenced by more than one stamped memorandum of sale or agreement to sell.[400]

DEFINITIONS. The term "exchange" includes each and every agency, office, room, or other place of assembly whether under shelter or in the open, at which stock, rights, warrants, interests in property, or in profits, or in accumulations, by corporations, are publicly bought, sold, bid for, offered or exchanged between persons there assembled, in behalf of themselves or others. The term "clearing house" includes every corporation or association, whether incorporated or not, of individuals, partnerships or corporations wholly or partly engaged in the business of clearing, settling, or adjusting transactions in the purchase, sale, receipt, or delivery of shares of stock, whether or not the same be a part or department of any exchange or an independent body.[401]

RECORDS OF SALES OR TRANSFERS OF STOCK. (a) All persons who are wholly or partly engaged in the business of buying, selling or transferring shares of stock, whether at public or private sale, or whether or not they are members of an exchange. including persons engaged in transactions known as "matched," or "on-order," or "pass-outs," or "give-ups," or settled directly between the seller and buyer, or cleared or adjusted through a clearing house or otherwise, or engaged in accepting and procuring the transmission of orders for purchase or sale of shares of stock shall keep a record showing:

[400] Reg. 40 Rev., Art. 15; Reg. No. 40, Part I, Art. 6. In McClain v. Fleishman, 106 Fed. 880, a stock broker entered into agreement with his customers to buy and sell stocks on a fixed price for future delivery. Each of such agreements was evidenced by the written memoranda properly stamped in accordance with the 1898 Law. The transfers were purely speculative, conducted on margins and no actual delivery was contemplated by the parties, settlement being made by a payment of differences and the surrender of the written memoranda. It was held that such settlements did not involve agreements for a resale of the stocks requiring new memoranda to be made and stamped, the court having no authority to infer such agreements contrary to the fact for the purpose of extending statutory provisions to transactions not within its terms.

[401] Reg. 40 Rev., Art. 33.

(1) Date of transaction.
(2) Line number (if at an exchange).
(3) Name of broker or salesman who executed the order.
(4) Name of party to whom sold, or from whom bought.
(5) Number of shares dealt in.
(6) Name or description of stock.
(7) Price of stock, if without face or par value.
(8) Amount (or total market value) of stock.
(9) Face or par value of stock per share.
(10) Tax paid on shares having face or par value.
(11) Tax paid on shares without face or par value.
(12) State tax paid, if any. (Optional.)
(13) Total amount to ledger. (Optional.)
(14) Folio number. (Optional.)
(15) Name of customer for whom sold or transferred, or for whom bought or transferred.
(16) Number of shares loaned or borrowed.
(17) Number of borrowed or loaned shares returned.
(18) Method of settlement or adjustment.

(b) Persons keeping such records may incorporate therein additional columns that will be of use to them, such columns to be placed so as not to interfere with the columns and headings hereby prescribed. These records must be in book form, and all entries therein must be legibly written in ink and the records kept for a period of at least two years. Such record forms will not be supplied by the department.

(c) The form of record required is known as Form A.

(d) Provided, however, that brokers known as strictly "floor brokers," or "two dollar men," or "room traders," in lieu of the foregoing record, whether their transactions are settled directly between seller and buyer or by "matched," "on-order," "pass-out," or "scratch sale," or "give-up," or any other kind of sale or purchase, or are cleared through a clearing house or otherwise, shall keep a record showing:

(1) The date of the transaction.
(2) The name of the seller.
(3) The name of the purchaser.
(4) The name of the stock.
(5) The number of shares.
(6) The par or face value of the shares.
(7) The price, if the stock has no par value.
(8) Whether the transaction is "matched," "on-order," "pass-out," "scratch sale," or "give-up."
(9) Name of person to whom "given-up."

(e) Provided further, that persons engaged in accepting and procuring the transmission of orders for the purchase or sale of shares of stock to be executed at a brokerage office or an exchange, board of trade, or similar place, shall keep a record showing:

(1) Date of acceptance and transmission of order.
(2) Name of person from whom accepted.
(3) Name and address of person to whom transmitted.
(4) Name of stock.
(5) Par value of stock.
(6) Number of shares.
(7) Whether purchase or sale.
(8) Price.
(9) Whether order was executed at an exchange; and, if so, what exchange.
(10) Date of execution of order.[402]

INTRAOFFICE BORROWING OF STOCK. The Revenue Act of 1921 provides that no stamp tax shall be imposed upon mere loans of stock nor upon the return of stock so loaned.[403] This provision was not contained in the Revenue Act of 1918 and the following rulings were made under that law: Intraoffice borrowing of stock is necessitated by a number of conditions, including actual short sales made and nominal short sales, such as the sale of stock which is in transit or in the possession of branch offices, which is not received in due time to make delivery. To make the required delivery in such a case the broker, assuming he has in his possession the kind of stock required (placed with him for sale or purchase by him for customers), borrows such stock and makes the necessary delivery. The stock so borrowed is not taken from any given account and the actual ownership thereof would, perhaps, be impossible to trace. It is taken from a general pool in which virtually all the stock of the office is held and the pool credited accordingly. When the physical stock arrives or is purchased and is replaced, the pool is debited and the particular stock involved balanced. This is usually the only office record kept of these transactions. It is understood that in all or in most intraoffice borrowings it is the pool that is involved and not the individual accounts of customers or clients.

Under the circumstances it would be meaningless to affix stamps to ledger accounts. It would also be inadvisable to affix stamps to the account kept with the pool for the reason that

402 Reg. 40 Rev., Art 16.
403 Revenue Act of 1921, Title XI, Schedule A-3.

the record is not sufficiently detailed, although such account is of considerable value in checking taxable transactions.

The following method of collecting the tax was first suggested by the Treasury Department: A ticket or memo should be executed covering each transaction of stock borrowed and the stamps affixed thereto. This ticket should show the date when the stock is taken from the pool, the name of the person for whose account the stock is borrowed, a description of the stock, and the number of shares. This ticket should bear a serial number and should be filed with other similar tickets consecutively in the broker's office; these tickets should be retained for two years.[404]

The following method was later suggested as protecting the Government and likely to be more acceptable to the broker:

A book of record may be kept consisting of loose or fixed leaves containing three columns, headed as follows: Column 1—Name of customer for whose account the stock is borrowed and description of the stock. Column 2—Date borrowed. Column 3—Date replaced. This record may be a running record, but care should be exercised to permit sufficient space for affixing thereto the stamps due. The heading and specimen line of such a record would appear thus:

Name of Customer and Stock	Date borrowed	Date returned
A. Smith, 100 shares U. P.	May 1, 1921 *	May 5, 1921

* Stamp and cancellation

Where intraoffice transactions to be tax paid are shown in similar detail by books or records already kept by the broker, and it is practicable and desirable to do so, he may be instructed to affix the proper stamps to those books or records in the tax-payment both of past and of current transactions, rather than be required to introduce a new record or to follow the method first suggested. The stamp tax on these intraoffice transactions is incurred when they are made and is properly to be paid by stamps affixed at the time of making. It would therefore not be a proper procedure for the broker to file a report with stamps affixed thereto at the end of the month or of a period, in tax-payment of past transactions shown. Where such a report constituted a current record with stamps currently affixed it should be retained in the broker's office for a period of two years.[405]

Returns by Persons Making Sales. (a) All persons who are wholly or partly engaged in the business of buying, selling or transferring shares of stock, whether such sales, purchases,

[404] O. D. 87, Ruling No. 202, March, 1921; W. T. S. 1921, ¶ 4031.
[405] O. D. 136, Ruling No. 260, June, 1921; W. T. S. 1921, ¶ 4053.

or transfers shall be made, cleared, settled, or adjusted through a clearing house, or otherwise, are required on or before the fifteenth day of each month, and at any other time designated by the Commissioner, to render under oath a true return of all such sales to the Commissioner for the preceding month or for any other period designated by the Commissioner, containing in detail the following data and information:

(1) The month for which the return is made.

(2) The name and address of the person, partnership, corporation, or association making the return.

(3) The number of shares sold, loaned, and borrowed returned, and tax paid as follows:

(a) Par value shares through clearing house.

(b) Par value shares ex-clearing curb, over the counter.

(c) No par value shares, market value $100.00 or less through clearing house.

(d) No par value shares, market value over $100.00 or less ex-clearing house, curb, over the counter.

(e) No par value shares, market value over $100.00 through clearing house.

(f) Market value no par value shares, market value of $100.00 through clearing house.

(g) No par value shares, market value over $100.00 ex-clearing house, curb, over the counter.

(h) Market value no par value shares, market value over $100.00 ex-clearing house, curb, over the counter.

(i) Transfers, calls, rights, when as and if issued, contracts and miscellaneous.

(4) Number of shares cross trades.

(5) The amount of tax paid.

(6) The amount of stamps on hand on the first day of the month, or other period.

(7) The amount of stamps purchased during the month, or other period.

(8) The amount of stamps on hand on the last day of the month for which return is being made.

(b) Provided that brokers known strictly as "floor brokers," or "two-dollar men" or "traders" in lieu of the foregoing return shall render a return only as to such sales as were not "given up" to or cleared through some other broker including direct settlements, "pass-outs," or "scratched sales."

(c) Provided further that in the event any broker who has not closed business shall make no sales of stock during any one

month he shall file with the Commissioner a statement to that effect in lieu of a return.[406]

Returns by Clearing Houses. (a) If any person, who negotiates sales or transfers of stock on a stock exchange, shall appoint in writing the clearing house for the exchange upon which such sales or transfers are made his agent for the purposes hereinafter indicated, and shall make to such clearing house a written return, statement, or sheet, on each business day, containing a full disclosure of all such transactions, both clearable and non-clearable, of the preceding day, in shares of stock that are listed or permitted to be dealt in by such member on such exchange, and also showing which, if any, of such stocks are loaned or borrowed or returned, then in that event such return, statement, or sheet, delivered to the clearing house, shall be deemed to be the bill or memorandum of sale or agreement to sell, required under subdivision 3, Schedule A, Revenue Act of 1921, and such clearing house is hereby authorized to affix to such return, statement, or sheet the amount of stamps required for each sale or agreement to sell or memorandum of sale or delivery or transfer of the stock indicated thereon, and to cancel the stamp so affixed. (b) The affixing and cancellation of such stamps by the clearing house shall be held to be the act of the person making such sale or agreement to sell, or memorandum of sale, or delivery or transfer of such stock; or if such person and clearing house so elect, such person shall affix and cancel such stamps before delivering such clearing house sheets or memoranda of sales to the clearing house, but such clearing house shall not accept such clearing house sheet or memoranda unless stamps for all transfer tax required to be affixed are attached thereto and properly canceled. (c) The returns, statements, or sheets made to the clearing house shall in respect of each sale show the date thereof, the name of the seller, the name of the buyer, the amount of the sale, and the name of the stock, or certificates, or other things traded in, but a return for more than one sale may be made upon the same return, statement or sheet; and no settlement of differences or other dealings between members shall be permitted that will interfere with the full disclosure of the whole transaction. (d) Said clearing house shall preserve the returns, statements, or sheets so made and stamped for at least two years. (e) Such return, statement, or sheet to the clearing house shall not relieve the seller from making and delivering to the buyer the bill or memorandum

[406] Reg. 40 Rev., Art. 17, as amended by T. D. 3103.

required by Article 15 of Regulations 40 (Revised). (f) When a clearing house carries upon its sheets or records information or reports of transactions showing the transfer by one of its members of an account of a customer without change of ownership of the securities of the customer, there shall be kept by the members of such clearing house or body concerned in such transaction a record showing the particulars of such transaction.[407]

STOCK TRANSFER STAMPS. (a) Ordinary documentary stamps with the words "Stock transfer" overprinted thereon, known as "Stock transfer stamps," shall be affixed to all sales or agreements, to sell, or memoranda of sales, or deliveries of or transfers of legal title to shares or certificates of stock or of profits, or of interest in property or accumulations of a corporation, joint-stock company, or association, and all "warrants," rights, and other securities, made at exchanges or similar places. (b) Ordinary documentary stamps may be affixed to sales, agreements to sell, or memoranda of sales not made at exchanges or similar places.[408]

Records and Returns Required in Case of Sales of Produce on Exchange. (a) Every person who makes sales, or agreements of sale, or ågreements to sell, any products or merchandise at or under the rules or usages, of any exchange, board of trade, or similar place, for future delivery, shall deliver to the buyer bill, memorandum, or other evidence of such sale, agreement of sale, or agreement to sell, to which there shall be affixed a lawful stamp in value equal to the amount of the tax on such sale. (b) Such bill, memorandum, or other evidence duly stamped shall be kept by the buyer for two years, unless otherwise prescribed by regulation. (c) No single sale or agreement of sale, or agreement to sell, made upon an exchange by one member for another need be evidenced by more than one stamped bill, memorandum, or agreement.[409]

CLEARING HOUSE AS AGENT. (a) If any person who makes sales, agreements of sale, or agreements to sell any products or merchandise at or under the rules or usages of any exchange, board of trade, or similar place, for future delivery, shall in writing appoint the clearing house for the exchange upon which such sales are made, his agent for the purposes hereinafter named, such clearing house being approved by the Commissioner,

[407] Reg. 40 Rev., Art. 18. For a definition of the term "clearing house" and "exchange" see Reg. 40 Rev., Art. 33. See p. 1225.

[408] Reg. 40 Rev., Art. 19.

[409] Reg. 45 Rev., Art. 25.

and shall make a written return or sheet of each sale to such clearing house in accordance with the regulations, such return or sheet shall be deemed to be the bill, memorandum, or other evidence required by the regulations to be delivered by the seller to the buyer, and the clearing house is authorized to affix to such return or sheet the amount of the stamps required for each sale, agreement of sale, or agreement to sell as indicated thereon, and to cancel the stamps so affixed. (b) The affixing and canceling of such stamps by the clearing house shall be held to be the act of the person making such contract of sale. (c) If the person making such sale and the clearing house so elect, the seller may affix the stamps to the clearing house return or sheet and cancel the same before or at the time of delivery to the clearing house. The clearing house shall in no event accept such bill, memorandum of sale, or clearing house return or sheet unless stamps for all the tax required to be paid thereon are attached and properly canceled. (d) The returns or sheets of sales so made to the clearing house shall in respect of each sale, set forth the date, the name of the seller, the name of the purchaser, the amount of the sale, the matter or things to which it refers and the tax paid thereon, but a return for more than one sale may be made on the same paper or sheet. (e) The clearing house shall preserve for a period of not less than two years, each bill, memorandum or return, or sheet made to it by such person. (f) Every clearing house shall include in its monthly return to the Commissioner a statement of the amount of stamps so affixed and canceled on the returns or sheets of each person. (g) The making of such return by the clearing house shall not relieve any person making such sale, or agreement of sale, or agreement to sell, from making the monthly return of his transactions required by the regulations.[410]

RECORDS TO BE KEPT BY BUYERS AND SELLERS. (a) All persons who make sales or agreements of sale of, or agreements to sell (including so-called "transferred or scratch" sales, "pass-outs," "pair-offs," "matched trades," or "give-ups") any product or merchandise at, or under the rules or usages of, any exchange for future delivery, or are engaged in the business of accepting and transmitting orders for the purchase of such products or merchandise to be executed at, or under the rules or usages of any exchange for future delivery, shall keep a record showing: (1) Date of contract. (2) Name of person executing contract (floor broker). (3) To whom sold or from

[410] Reg. 40 Rev., Art. 26. See Reg. 40 Rev., Art. 29.

whom bought (name and address). (4) Whether transaction is a purchase or sale. (5) Quantity of product or merchandise involved, whether in tons, pounds, bales, bushels, bags, mats, barrels, gallons, or whatever other unit of weight or measure is used. (6) Name of product or merchandise, including (if not a basis grade) grade, type, sample, or description. (7) Whether contract is a "basis-grade," "deferred acceptance," or whatever kind of contract. (8) Price specified per ton, pound, bale, bushel, bag, mat, barrel, gallon, or whatever other unit of weight or measure is used. (9) Tax paid. (10) Customer (name and address). (11) Origin of order (whether domestic or foreign). (12) Month or time specified in contract for delivery. (13) Date of settlement. (14) Method of settlement or adjustment. (b) Provided, that "floor brokers," or "two-dollar men," or "room traders," in lieu of the foregoing records shall keep a record showing: (1) Date of transaction. (2) Name of person who executed the order, if other than the floor broker. (3) Name of seller. (4) Name of buyer. (5) Quantity of product or merchandise involved in the transaction. (6) Name of product or merchandise, including (if not a basis-grade contract) grade, type, sample, or description. (7) Whether the contract is a basis-grade contract. (8) Price. (9) Time specified in contract for delivery. (10) Name of persons to whom "given up," "paired off," "transferred or scratched," or "passed-out." (c) And other transactions than those specified in this proviso made by "floor brokers," "two-dollar men," or "room traders," shall be kept on the first form described in this paragraph. (d) Persons who use either of such forms may incorporate additional columns which may be of use to them, such columns to be so placed as not to interfere with the columns and headings herein prescribed. (e) Such record forms will not be supplied by the department. (f) The foregoing records shall be legibly written in ink, and contracts of sale for future delivery of two or more distinct products or merchandise shall be kept separate. Each person who executes or makes such contracts of sale shall preserve the books, bills, memoranda, "sales tickets," or trading cards of all transactions, and the purchaser shall preserve the bill, memorandum, agreement, or evidence of sale to which the stamps are affixed for the period of two years, that they may be readily inspected by the revenue officer. (g) The form of record required is known as Form B.[411]

[411] Reg. 40 Rev., Art. 27.

RECORDS TO BE KEPT BY CLEARING HOUSES. (a) All persons who acted in the capacity of a clearing house shall keep a record showing: (1) Name of person for whom each contract is cleared. (2) Date when contract was made. (3) Whether the transaction is a purchase or sale. (4) Quantity of product, or merchandise, involved, whether in tons, pounds, bales, bushels, bags, mats, barrels, gallons, or other unit of weight or measure, as the case may be. (5) Name of product, or merchandise, including (if not a "basis-grade" contract) grade, type, sample, or description. (6) Whether the contract is a "basis-grade" contract. (7) Time specified in contract for delivery. (8) Date of settlement. (9) Method of actual settlement. (b) Records of sales for future delivery of two or more distinct products or merchandise must be kept separate. (c) The clearing house shall preserve such records for the term of two years. (d) Such record forms will not be supplied by the department.[412]

RETURNS OF TRANSACTIONS. (a) All persons who make contracts of sale or purchase of any product or merchandise, at or under the rules or usages of any exchange, board of trade, or other similar place of business, for future delivery, whether such contracts shall be cleared and adjusted through a clearing house or directly between the seller and buyer, or otherwise, shall on or before the fifteenth day of each month, or at any other time required by the Commissioner, make a return in writing to the Commissioner, for the preceding month of any other period, verified before some officer authorized to administer oaths, showing (1) The number of contracts of sale and purchase of each product or merchandise brought forward from the preceding month or period. (2) The number of contracts of sale and purchase of each product or merchandise on each day during the current month or period. (3) The months in which the products or merchandise are to be delivered. (4) The method of settlement of each contract, i. e., whether by "actual delivery," "notice," "ring," "direct," "transfer," "scratch sale," "pass out," "matched," "pair off," "set-off," "give up," through a clearing house or otherwise. (5) The tax paid thereon. (6) The number of contracts both of purchase and sale carried forward at the end of the month or period. (7) The amount of stamps on hand at beginning of month or period. (8) The amount of stamps purchased during month or period. (9) The amount of stamps used during month or period. (10) Bal-

[412] Reg. 40 Rev., Art. 28.

ance of stamps on hand at end of month or period. (11) The origin of the order or the contracts, whether domestic or foreign. (b) Provided, that "floor brokers," or "two-dollar men," or "room traders" may omit from their returns information called for under paragraphs marked (1), (6), and (11). But in the event such "floor brokers," "two-dollar men," or "room traders" shall make or settle transactions in any other way than by "transferred or scratch sales," "give ups," or "pass outs," they shall make the full returns prescribed in this paragraph. (c) Such returns shall be made upon forms to be furnished, upon application, by the Collector of Internal Revenue, of the districts in which the exchange, board of trade, or other similar place is located.[413]

Returns by Clearing Houses. (a) Every clearing house shall on or before the fifteenth day of each month, and at such other times as required by the Commissioner, make return in writing, under oath, to the Commissioner, for the preceding month or other period, showing (1) The number of open contracts "long" and "short" brought forward for each member from the preceding month. (2) The number of contracts bought and sold by each member of the association. (3) The number of tons, pounds, bales, bushels, bags, mats, barrels, or gallons, or other units of weight or measure involved in such contracts, as the case may be. (4) The month in which such product, merchandise, or commodity is to be delivered. (5) The method of settlement of said contracts, i. e., whether by "set off," "notice," or "delivery," or by what method. (6) Total tax paid by each member of the exchange. (7) The number of open contracts "long" and "short" carried forward for each member to the following month. (b) Such returns shall be made upon forms to be furnished, upon application, by the collector of internal revenue of the district in which the clearing house is situated.[414]

Stamps May Be Affixed to Returns. (a) If any exchange shall by proper resolution request the Commissioner to permit the members of such exchange to affix the requisite amount of stamps on the returns made by such members to the Commissioner of all transactions made by such member at such exchange and cancel such stamps, and shall file with the Commissioner a copy of the charter and by-laws of such exchange accompanied with a list of the names and addresses of the

[413] Reg. 40 Rev., Art. 29.
[414] Reg. 40 Rev., Art. 30.

officers and members of such exchange, designating those of such members who are active and those who are inactive on the exchange, then upon approval of such resolution by the Commissioner, instead of affixing the stamps to the bill or memorandum of sale as now required, it shall be lawful for the members of such exchange to affix the amount of stamps on such returns as shall represent the aggregate amount of tax due on all sales, agreements of sale, or agreements to sell, made by such member during the preceding month or other period designated by the Commissioner and such stamps shall be canceled by such member in the manner prescribed in the regulations. (b) Such returns, duly stamped, shall be filed and preserved for two years. (c) The stamping and filing of such returns shall not in any way relieve the members of such exchange from making and delivering to the buyer the memorandum or bill of sale prescribed by law and the regulations, nor the buyer from the necessity of preserving the same for the term of two years.[415]

FUTURE DELIVERY STAMPS. The stamps to be used on sales, agreements of sale, or agreements to sell products or merchandise at or under the rules or usages of any exchange, or board of trade, or other similar place, for future delivery shall be the ordinary documentary stamps with the words "Future delivery" overprinted thereon, and they shall be known as "Future delivery stamps."[416]

Registration of Brokers, etc. (a) Every person engaged, in whole or in part, in any of the following businesses or activities shall file a statement for registration with the collector of internal revenue of the district in which his principal office or place of business is located: (1) Persons engaged in negotiating, making, or recording sales, agreements to sell, deliveries or transfers of shares or certificates of stock, or rights, or warrants, or certificates of beneficial interest in profits, property, or accumulations of a corporation. (2) Persons conducting or transacting a stock brokerage business. (3) Persons accepting or procuring the transmission of orders for the purchase or sale of transfer of stocks, rights, warrants, certificates of beneficial interest, or interests in property, profits or dividends, to be executed at a stock brokerage office or an exchange or similar place. (4) Persons engaged in the business of transferring stock other than their own. (5) Persons engaged in making

415 Reg. 40 Rev., Art. 31.
416 Reg. 40 Rev., Art. 32.

sales or agreements of sale of, or agreements to sell, any products or merchandise at, or under the rules or usages of, any exchange, for future delivery; or engaged in the business of accepting or procuring the transmission of orders for such contracts of sale to be executed at an exchange, or under the rules or usages of an exchange, for future delivery. (6) Persons engaged in conducting an exchange or clearing house or clearing association for the clearing, adjusting, and settling transactions made on exchanges or similar places: Provided, That in case the person conducting such an exchange has a department connected therewith engaged in clearing, adjusting, and settling the transactions made on such exchange, he shall so state and shall give the names and addresses of the superintendent and secretary of each such clearing house division or committee. (b) If the person required to file a statement for registration is also a member of an exchange, a seat on which is worth $2,000 or more, he shall state the average value of such seat for the year ending June 30 immediately preceding his registration. (c) In the case of a partnership of which two or more members are members of exchanges, the names of such members and of each exchange in which memberships are held shall be stated, together with the price of a seat on each exchange. (d) The statement above required shall be verified on oath by the person required to make such statement, or by the president or secretary of a corporation, association, or clearing house, and shall set forth specifically the character of the business to be conducted and the full name and address of each person or member of a partnership engaged in such business: Provided, that in the case of a corporation or association, the statement for registration shall set forth the date and place of incorporation and the principal office or place of business both within and without the State where incorporated, and the names and addresses of the chief officer and secretary of such corporation, and be accompanied with a list of the members and their addresses. (e) Each exchange or clearing house shall also file with such collector a copy of its constitution, charter, or agreement of association and by-laws, rules and regulations, and all amendments thereto as the same may from time to time be adopted, and the names and addresses of new members as from time to time admitted to membership. (f) If the person or corporation required to file such statement has been licensed under the laws of any State or under any other provision of Federal law the date and place at which such license was issued shall be stated. (g) In case a person registered as required by

the regulations shall suspend or close his business before the end of the year for which he is registered, he shall file in the office of the collector of internal revenue in which he is registered a certificate to that effect, giving the date on which he suspended or closed his business. (h) Such statement for registration shall be made on a form to be furnished upon application to the collector of internal revenue.[417]

RECORD OF REGISTRATION KEPT BY COLLECTOR. (a) Every collector shall file and preserve each statement for registration filed with him in accordance with the regulations, and shall issue to each person, partnership, exchange, clearing house or corporation a certificate of registration, showing the date of issue, the name of the person, or exchange, clearing house, or corporation, conducting the business, the nature of the business for which the license is granted, and the date of expiration of said registry, which certificate of registration shall be signed by the collector, and shall be posted in some prominent place in the office of said person, partnership, exchange, clearing house, or corporation during the period for which it is issued. (b) If such business is conducted at more than one place, a certificate shall be posted in each place of business.[418]

Sale of Stamps. (a) No person other than a Collector of Internal Revenue, or duly authorized deputy collector of Internal Revenue, Assistant Treasurer, or designated United States depositary shall sell or expose for sale, give away, traffic in, trade, barter, lend, borrow, or exchange any stamps, issued pursuant to the regulations: Provided, That any person or corporation which has been duly appointed and constituted and is acting agent of any State for the sale of stock transfer stamps of such State, may upon giving bond in a sum to be fixed by the Commissioner, sell United States stamps issued pursuant to the regulations when approved and authorized by the Commissioner. (b) No person shall buy, receive, or have in his possession or under his control, any stamps issued pursuant to the regulations, unless such stamps have been purchased directly from the Collector of Internal Revenue, or duly authorized Deputy Collector of Internal Revenue, Assistant Treasurer designated United States depositary, or a designated agent for the sale of State stock transfer stamps authorized by the Commissioner, in the district in which the stamps are to be used. (c) All requisitions for stamps to be used under these regulations shall be made in writing on a form prescribed by the Commissioner to the Collector of Internal Rev-

417 Reg. 40 Rev., Art. 34.
418 Reg. 40 Rev., Art. 35.

enue or duly authorized Deputy Collector of Internal Revenue, Assistant Treasurer or designated United States depositary or state agent authorized by the Commissioner, in the Internal Revenue district in which the stamps are to be used, giving the date thereof, the number and denomination of stamps applied for and the name and address of the purchaser, and shall be signed in ink by the person receiving such stamps. (d) If the requisition for such stamps shall be made to any Assistant Treasurer or designated United States depositary or duly authorized state agent for sale of state stock transfer stamps, such Assistant Treasurer or designated United States depositary or duly authorized state agent shall keep a record thereof, and at the end of each month shall file with the Collector of Internal Revenue of the district a statement setting forth the number, denomination, and amount of all stamps on hand at the beginning of each month, the number, denomination and amount sold during the month, and the number, denomination and amount on hand at the end of the month, accompanied by the requisitions, filed by each purchaser, and on or before the fifteenth day of each month shall pay over to such Collector of Internal Revenue all money received from sales of such stamps for the preceding month, taking his receipt therefor. (e) The Collector of Internal Revenue shall keep the requisitions for stamps sold by him and those sold by such Assistant Treasurer, designated United States depositary or authorized state agent separate and apart from all other requisitions for stamps and shall preserve them in his office for a period of two years.[420]

Penalties. Several penalties are provided in Title XI of the Revenue Act of 1921, which are dealt with in the following paragraphs. The act, omission, or failure of any official, agent or other person or corporation, employed by any person, partnership, company, association or corporation, within the scope of his employment or office, will in every case be deemed also the act, omission, or failure of such principal.[421]

ISSUING OR ACCEPTING UNSTAMPED INSTRUMENTS. Anyone who makes, signs, issues or accepts an instrument without the full amount of the tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[422]

[420] Reg. 40 Rev., Art. 39.

[421] Reg. 40 Rev., Art. 33.

[422] Revenue Act of 1921, § 1102. The word "accept" is used in this section in the general sense of "receive," not in the special sense peculiar to drafts. (T. D. 2682.)

SELLING PLAYING CARDS WITHOUT PAYING THE TAX. Anyone who manufactures and imports or sells any playing cards, package or other article without the full amount of tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[423]

FAILURE TO CANCEL STAMPS. Anyone who makes use of a stamp without cancelling or obliterating the same is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[424]

FRAUDULENT REMOVAL OR REUSE OF STAMPS. The penalty for fraudulent removal or reuse of a stamp or having possession of washed, restored or altered stamps removed from any instrument is a fine of not more than $1,000 or imprisonment for not more than five years, or both, and the reused, cancelled or counterfeit stamp together with the document, package or article upon which it is placed or impressed may be forfeited to the United States.[425]

TRANSFERRING STOCK WITHOUT PAYING TAX. Any person liable to pay the tax on sales or transfers of capital stock or certificates of profits or any one acting as agent or broker for such person, who makes any sale, or in pursuance of a sale delivers any certificate or evidence of the sale of any stock, interest or right or bill or memorandum thereof, without the proper stamps affixed thereto with intent to evade the law is guilty of a misdemeanor punishable by a fine of not more than $1,000, or by imprisonment for not more than six months, or both.[426]

MAKING SALES OF PRODUCE WITHOUT PAYING TAX. Any person liable to pay the tax on sales of produce on any exchange or anyone acting as agent or broker for such person, who makes any sale, or agreement of sale or agreement to sell, or pursuant there-

[423] Revenue Act of 1921, § 1102. The Act of August 28, 1894, also imposed the following penalties: § 39. Adhesive stamps to be affixed to each package and canceled by the person using the stamp. Penalty, $50.00. § 40. Manufacturer to register with the collector of the district. Failure to register, penalty, $50.00. § 42. Penalty for counterfeiting, defacing, or removing stamp or illegal use of the same, fine of $1000.00, 5 years' imprisonment, or both, at the discretion of the court. § 43. Penalty for removal or sale of playing cards (except for export) without having stamps affixed, $50.00. § 44. Manufacturer removing or reusing any stamp, wrapper, or cover for the purpose of evading the tax liable to a fine of $50.00 and forfeiture. § 45. Penalty for selling or exposing for sale, removing, or concealing playing cards without having affixed the stamp thereto, $50.00 and forfeiture. (See T. D. 2817.)

[424] Revenue Act of 1921, § 1102.

[425] Revenue Act of 1921, § 1103.

[426] Revenue Act of 1921, Title XI, Schedule A-3.

to, delivers any products or merchandise without a bill, memorandum or other evidence thereof, or who delivers such bill, memorandum or evidence, without having the proper stamps affixed thereto, is guilty of a misdemeanor punishable by a fine of not more than $1,000, or by imprisonment for not more than six months, or both.[427]

FAILURE TO STAMP INSURANCE POLICIES. Any person to or for whom or in whose name any insurance policy, taxable under Title XI is issued, or any solicitor, agent or broker acting for or in behalf of such person in the procurement of any such policy, for failure to affix the proper stamps with intent to evade the tax, in addition to other penalties provided herefor, will be obliged to pay a fine of double the amount of the tax.[428]

OTHER PENALTIES. The present law contains no provision that an unstamped instrument shall be void or shall not be admitted as evidence in the courts or shall not be placed on record. But Sections 13, 14 and 15 of the Act of June 13, 1898, as amended by the Act of March 2, 1901, are held by the Treasury Department to be still in force, and to apply to deeds to the extent that they forbid the record and admission in evidence of unstamped deeds and require their presentation to the collector of the district for validation.[429] Section 13 makes provision for the stamping of documents issued without stamps; Section 14 that unstamped instruments are not admissible in evidence; and Section 15 that unstamped instruments shall not be recorded.[430]

This view of the Treasury Department has been upheld by a Federal District Court[431] but in a recent case[432] decided by the United States Supreme Court it has been held that Sections 13, 14 and 15 of the 1898 Law have no application under the 1914 Law. This case appears to be conclusive with respect to the 1918 and 1921 Laws as well as to the 1914 Law. The court said in part:

"As to the absence of revenue stamps, it is true that the deeds showing title in some of the plaintiffs—they were produced in evidence over the defendant's objection—were without the stamps required by the act of October 22, 1914, c. 331, Sec. 22,

427 Revenue Act of 1921, Title XI, Schedule A-4.

428 Revenue Act of 1921, Title XI, Schedule A-13; T. D. 2891.

429 Letter from treasury department dated May 27, 1918; W. T. S. 1919, ¶ 3717. §§ 2, 4, 6, 12, 18, 20, 21, 22, 23, 24, 25, Schedule A, Schedule B, §§ 27, 28, 29 and 50, of the Act of June 13, 1898, were expressly repealed by the Act of April 12, 1902. (32 Stat. 96.)

430 The sections are printed in full at the end of this book.

431 U. S. v. Masters, 264 Fed. 250.

432 Cole et al. v. Ralph, 252 U. S. 286.

Schedule A, 38 Stat. 762. But this neither invalidated the deeds nor made them inadmissible as evidence. The relevant provisions of that act, while otherwise following the language of earlier acts, do not contain the words of those acts which made such an instrument invalid and inadmissible as evidence while not properly stamped. Those words were carefully omitted, as will be seen by contrasting Secs. 6, 11, 12 and 13 of the act of 1914 with Secs. 7, 13, 14 and 15 of the act of 1898, c. 448, 30 Stat. 454. From this and a comparison of the acts in other particulars it is apparent that Congress in the later act departed from its prior practice of making such instruments invalid or inadmissible as evidence while remaining unstamped and elected to rely upon other means of enforcing this stamp provision, such as the imposition of money penalties, fines and imprisonment. The decisions upon which the defendant relies arose under the earlier acts and were based upon the presence in them of what studiously was omitted from the later one."

EXCLUDING UNSTAMPED DOCUMENTS IN STATE COURTS. There is some conflict of authority on the question whether the federal government has any authority under the constitution to prescribe rules of evidence for the state courts, and to preclude the acceptance in evidence of unstamped or improperly stamped instruments in the state courts. There are cases holding expressly that the federal government has such power, or holding to the same effect by excluding unstamped or improperly stamped documents,[433] but the weight of authority and the best considered cases seem to establish a contrary rule.[434] One of the best statements on the subject, contained in a Georgia case,[435] which arose under the 1898 Law, of which the above sections 13, 14 and 15 once formed a part, reads as follows: "We fully recognize the power of Congress to levy and collect taxes for the support of the

433 Chartiers etc. Co. v. McNamara, 72 Pa. St. 278; Hoops v. Dunham, 41 Ga. 109.

434 Peo. ex rel. Barbour v. Gates, 43 N. Y. 40; Moore v. Moore, 47 N. Y. 467; Rowe v. Bowman, 183 Mass. 488, 67 N. E. 636; Davis v. Evans, 133 N. C. 320, 45 S. E. 643; Cassidy v. St. Germain, 22 R. I. 53, 46 Atl. 35; Garland v. Gaines, 73 Conn. 662, 49 Atl. 19; Clemens v. Conrad, 19 Mich. 170; Sammons v. Halloway, 21 Mich. 162; Craig v. Dimock, 47 Ill. 308; Duffy v. Hobson, 40 Cal. 240; Pargoud v. Richardson, 30 La. Ann. 1286; Knox v. Rossi, 25 Nev. 96, 57 Pac. 179, 48 L. R. A. 305 (note). Many more cases could be cited to the same effect, but the above are leading cases, and it is believed that they will furnish a guide to a complete list of the authorities.

435 Small v. Slocumb, 112 Ga. 279, 37 S. E. 481. This case contains an exhaustive examination of the authorities, and expressly disapproves of Chartiers etc. Co. v. McNamara, 72 Pa. St. 278.

government. We fully recognize its power to do this by the imposition of stamp duties, and to prescribe penalties for their nonpayment. We also recognize its power to regulate the practice and procedure and to provide rules of evidence in courts established under the constitution of the United States. After much reflection and a careful and thorough investigation of cases in the courts of other states, we have come to the conclusion, however, that Congress has no power to prescribe rules of evidence for a state court. Under our system of government, the states retained all powers of sovereignty which were not granted to the general government by the constitution. They had the power to create and establish their own courts, and to regulate the practice and procedure, and to prescribe rules of evidence therein. There is nothing in the constitution of the United States, which expressly or by implication gives to Congress the power to prescribe rules of evidence for the courts of the states. Of course Congress, having the power to impose stamp duties, has the power to provide for the enforcement of their payment by any necessary and proper means. But while to make unstamped instruments inadmissible in evidence in State courts would doubtless aid in compelling the payment of the tax, we think that such a method of collection is neither necessary nor proper, and is therefore not within the power of Congress. The act of 1898 subjects to a penalty any one who fails or refuses to comply with the provisions as to stamping written instruments, and the Federal courts have ample machinery for the enforcement of this penalty. No other method of enforcement would seem to be necessary, but, even if it were, Congress has power to provide that no unstamped instrument shall be received in evidence in any of the Federal courts. An attempt to extend this provision so as to make it applicable to the courts of the several states can not, therefore, be defended upon the ground that it is necessary. Nor do we think it a proper means of enforcing the stamp act to interfere with courts peculiarly within the control of the several states, by declaring what shall or shall not be used as evidence in them, or to seek to make the state courts punish a failure to comply with the federal stamp act by refusing to allow unstamped documents to be used as evidence in them." These state decisions have no application to Federal courts, where the laws of Congress, prescribing rules of evidence, must be observed.[436] And it has been held that even though a deed improperly stamped is admissible in evidence in the state courts, a purchaser at a judicial sale is entitled to a

436 Sackett v. M'Caffrey, 131 Fed. 219.

deed which will defend his title in any tribunal where it is attacked or where he is called upon to assert it, and that a referee to sell must affix the required stamps to his deed to such purchaser.[437]

VOIDING INSTRUMENTS FOR FAILURE TO STAMP. It is held that a deed, note or other instrument is not rendered absolutely void by a failure to stamp it properly,[438] but it is also held that such deed, note, or other instrument, is rendered void if the omission to stamp the same is wilful or with intent to evade the tax.[439] The point is in some confusion and no general rule can be safely formulated. It has been held by a state court that a note which lacks the stamping required by the 1916 and 1918 Federal Laws is not "complete and regular on its face" and the purchaser of such a note is not a holder in due course.[440]

Suits for Collection of Stamp Taxes. Following the rule that the government may recover duties upon imports as a personal indebtedness of the importer, it has been held under the 1898 Law that there is nothing in the nature of a stamp tax which *per se* negatives either the personal obligation otherwise to be derived from the words imposing the tax, or its collection by action; (2) the stamp is only the evidence, and its purchase the convenient means, of payment, so that when a statute says that a person shall *pay*, it obviously imposes upon that person a *duty* to pay which may be enforced through the ordinary means adapted to the recovery of a definite sum due, unless that course is clearly prohibited; (3) the penalties contained in the act were provided to induce the payment of the tax and not as a substitute for payment, and such provisions do not preclude the idea of personal liability; (4) the punitive provisions invalidating unstamped instruments offer an escape through a voluntary payment and therefore do not deprive the government of the right to compel payment by action; (5) the act itself provides by reference to the Revised Statutes and the administrative, special or stamp provisions of law that payment may be enforced by action.[441]

[437] Loring v. Chase, 26 Misc. 318; 56 N. Y. Supp. 312.

[438] Moore v. Moore, 47 N. Y. 467; Goodwine v. Wands, 25 Ind. 101; Adams v. Dale, 29 Ind. 273; D'Armond v. Dubose, 22 La. Ann. 131.

[439] Dowell v. Applegate, 7 Fed. 881; Rowe v. Bowman, 183 Mass. 488, 67 N. E. 636; Cassidy v. St. Germain, 22 R. I. 53, 46 Atl. 35; Hooper v. Whitaker, 130 Ala. 324, 30 So. 355; Harvey v. Wieland, 115 Ia. 564, 88 N. W. 1077; Ohio R. Junc. R. R. Co. v. Penna. Co., 222 Pa. St. 573, 72 Atl. 271.

[440] Lutton v. Baker, 187 Ia. 753, 174 N. W. 599.

[441] U. S. v. Chamberlin, 219 U. S. 250.

Constitutionality of Stamp Taxes. The constitutionality of various stamp tax acts has only been attacked on certain grounds and in reference to particular clauses, and no general deduction can be made as to the constitutionality of the present statute *in toto.* In one of the leading cases on the subject[442] it was decided that the 1898 Law was valid, in so far as it placed a stamp tax upon sales, agreements of sale, or agreements to sell any products or merchandise at any exchange or board of trade, or other similar place, either for present or future delivery. The court held that the tax was not a direct tax, but a duty or excise tax laid upon the privilege or opportunity afforded by boards of trade or exchanges for the transaction of business, although the amount of the tax was measured by the value of the property sold; and that it was immaterial that the tax could not be added to the price of the thing sold. The tax was also held to be uniform both in the geographical sense and in the sense that it taxed all taxpayers similarly situated, since there was a reasonable basis of classification in taxing all sales on exchanges. The court ruled further that the tax was not invalid or discriminatory (a) because it applied only to sellers and not to purchasers (b) because it did not tax the same privilege when used for all purposes, and (c) because it required a person selling property in intra-state commerce to make a memorandum, this being a proper means for the collection of the tax and a legislative question. The stamp tax on a memorandum or contract of sale of a certificate of stock imposed by the 1898 Law was held not to be a direct tax, but to fall within the class of duties, imposts and excises permitted under the first clause of Section 8 of Article 1 of the Constitution.[443] It has been held that the statute[444] giving the Commissioner of Internal Revenue power to require persons, who fail or refuse to make proper returns for stamp tax as well as other tax purposes, to produce their books, is not unconstitutional, since an order to produce books is not violative of the rights of a witness, though such rights may be invaded after his appearance.[445] In a recent case[446] it was contended that the 1914 Law was unconstitutional and void if it imposed a tax of any

[442] Nicol v. Ames, 173 U. S. 509.

[443] Thomas v. U. S., 192 U. S. 363. For a full discussion of the subject see the opinion of the lower court, 115 Fed. 207.

[444] R. S. § 3173.

[445] Calkins v. Smietanka, 240 Fed. 138.

[446] Home Title Ins. Co. v. Keith, 230 Fed. 905. This case contains a lengthy discussion of the authorities holding in favor of the constitutionality of the statute.

kind upon the deed given by a referee in pursuance of the order and as a part of the procedure of a State Court. It was held that the Act was not invalid in this respect as imposing a tax on the state's exercise of its governmental functions, since the tax imposed was an excise tax on the business transaction involved in the purchase of the land from the referee and its transfer to the purchaser, and that the transfer was in its nature the same as any transfer from one individual to another. But the 1898 Law so far as it attempted to impose a tax on charter parties used exclusively for the carriage of cargo from ports in the United States to foreign ports, was held to be a direct, and not incidental, tax on exports or exportation and, therefore, in this respect unconstitutional.[447] It is probable that the present law would not be upheld if it were construed in any way to place a tax upon exports or exportation.[448] And it seems that any construction of Sections 13, 14 and 15 of the 1898 Law, which are held to be still in force,[449] whereby unstamped or improperly stamped deeds, notes or other instruments, were denied admission in evidence in State courts would render the section unconstitutional as an attempt on the part of the federal government to prescribe rules of evidence for the State courts.[450] Consequently such sections probably apply only to the federal courts, since it is a well-known rule of statutory construction that where a statute admits of two constructions, one of which presses it beyond constitutionality and the other of which brings it within constitutionality or avoids the question, the courts tend to adopt the latter interpretation.[451] An amendment to the stock transfer act of New York imposing a tax of 2 cents "*on each share* of one hundred dollars of face value or fraction thereof"

[447] U. S. v. Hvoslef, 237 U. S. 1. Compare with Simpson v. Treat, 126 Fed. 1003.

[448] See T. D. 2682. Letter from treasury department dated April 13, 1918; W. T. S. 1918, § 3707; letter from treasury department dated January 24, 1918; W. T. S. 1918, ¶ 3683.

[449] Letter from treasury department dated May 27, 1918; W. T. S. 1918, ¶ 3723.

[450] See paragraph on Excluding Unstamped Documents in State Courts, p. 1242.

[451] See paragraph Construction Which Will be Constitutional in the chapter on Construction of the Law. In Sackett v. McCaffrey, 131 Fed. 219, the court declined to discuss the correctness of the state decisions adopting the interpretations of §§ 13, 14, and 15 of the Act of June 13, 1898, which restrict the prohibition against the admission of unstamped documents as evidence to the federal courts and thus saves the sections from unconstitutionality.

[451] Peo. v. Mensching, 187 N. Y. 8.

instead of "on each one hundred dollars of face value or fraction thereof" as provided in the original law, was held unconstitutional on the ground that such amendment taxed the sale of all shares of the face value of one hundred dollars and also all shares of the face value of any fraction of one hundred dollars, the words "fraction thereof" being held to relate to "share" rather than to "one hundred dollars"; and that therefore the tax was measured by the number of shares regardless of face value instead of the face value of the shares; that all corporate shares were placed in a class, but all members of the class were not treated alike; that the statute bore heavily upon some and lightly upon others in the same situation without method or order or reason and resulted in arbitrary or accidental selection rather than classification. While wide latitude in classification is possessed by the legislature, this power is not without the limitation that any classification adopted must have some basis, reasonable or unreasonable, other than mere accident, whim or caprice and must not result in an arbitrary discrimination in favor of one as against another of the same class. So far as the tax on the issue and sales or transfers of certificates or shares without par or face value of which the actual value does not exceed $100 per certificate or share is concerned, the Revenue Act of 1918, like the above unconstitutional amendment imposes a tax without reference to the actual value of the certificates or shares issued or transferred and in many cases would seem to constitute arbitrary selection rather than constitutional classification.[452] In construing the 1914 Law as imposing a tax upon the issue of certificates of shares issued by a manufacturing company organized in the form of a trust under the common law and deriving none of its rights, benefits or qualifications from any statute, and which was not an ordinary common law real estate trust, the Court has sustained the constitutionality of the law, holding it not invalid on the theory that it was inapplicable to other associations. The tax was stated to be merely on muniments of title so that, if other associations did not issue such muniments of title, they were accordingly not taxable.[453]

Payment Under Protest and Duress. The general rule of law, that a voluntary payment of money cannot be recovered, applies to stamp taxes. A person, therefore, who wishes to recover the amount of any stamp tax, which he considers illegally exacted, should pay the tax under protest and such payment should be

[452] Malley v. Bowditch, 259 Fed. 809; Edwards v. Wabash Ry. Co., 264 Fed. 610.

[453] Chesbrough v. U. S., 192 U. S. 253.

involuntary and under duress. Stamp taxes paid under protest or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, may on occasion be recovered, although generally speaking even a protest or notice will not avail if the payment be made voluntarily with full knowledge of the circumstances and without any coercion by the actual or threatened exercise of power possessed by the party exacting or receiving the payment over the person or property of the party making the payment from which the latter has no other means of immediate relief than such payment. The rule is firmly established that stamp taxes voluntarily paid cannot be recovered back and that payments with knowledge and without compulsion are voluntary. Thus, in a case[454] in which certain stamps were purchased from the collector who was not informed when the purchase was made of the particular purpose and who was given no intimation of any claim that the purchaser was acting under duress, recovery was denied even though the purchaser affixed the stamps in order to complete the transaction between himself and the vendee named in the deed to be stamped and to obtain the consideration for the property transferred. It was held that this transaction, while it might have constituted duress as between the parties to the deed, was a matter with which the collector had nothing to do and that the payment to the collector for the stamps was purely voluntary. The written application to the Commissioner to recover the amount paid for the stamps was held not to be the statutory equivalent of a common-law protest or notice of suit. While the Commissioner under the Revised Statutes[454] might have refunded the amount of such tax, an appeal was not permitted from his refusal to refund because it was not a ruling either specific or resulting from a demand, to which the taxpayer yielded under the protest and with notice, and from which he appealed to the Commissioner of Internal Revenue. Likewise, where a stamp tax was paid on manifests of cargoes on certain vessels bound to foreign ports as required by the 1898 Law, no information having been given to the person from whom the stamps were bought of the particular purpose, or claim made to the collector or Commissioner that the tax was unconstitutional, and no claim having been made to the collector of the port of New York that the taxpayer was acting under restraint and yielding only to enable his ship to depart, recovery was denied because the tax was not paid under duress, even though clearance papers could not be procured without the

[454] R. S. § 3220.

delivery to the collector of the port of outward foreign manifests of cargo properly stamped, and even though the master of a vessel failing to deliver the proper manifest and to obtain a clearance, was subject to a penalty.[455]

Injunctive Relief. The general rule that a taxpayer may not resort to a suit to restrain the assessment or collection of any tax applies to stamp taxes, and a taxpayer is not entitled to an injunction to restrain the Commissioner of Internal Revenue from assessing the taxes on sales of grain to which no stamps have been affixed, the only remedy to the taxpayer in such case being by suit to recover the tax.[456]

[455] U. S. v. N. Y. & Cuba etc. Co., 200 U. S. 488.

[456] Calkins v. Smietanka, 240 Fed. 138. See R. S. §§ 3224, 3226.

CHAPTER 46

TAX ON EMPLOYMENT OF CHILD LABOR

This tax was a new feature of the internal revenue laws of the United States, first introduced by the Revenue Act of 1918 and continued without change by the Revenue Act of 1921, designed to effect the abandonment of child labor in the establishments specified in the law.[1] The rulings on this subject in addition to Regulations 46, are in the form of letters and are compiled in "Child Labor Tax Rulings," revised September, 1920.

Effective Date of the Act. The tax went into effect beginning sixty days after the passage of the Revenue Act of 1918.[2] The Revenue Act of 1918 was signed by the President on February 24, 1919, and the effective date was therefore April 25, 1919. The first taxable year, that is, the taxable year 1919, consisted of the period between April 25, 1919, and December 31, 1919, both inclusive, or any fiscal year ending within the same period.[3]

Persons to Whom the Tax Applies. The tax applies to any individual, corporation, partnership, association, joint-stock company, or insurance company operating a (1) mine, (2) quarry, (3) mill, (4) cannery, (5) workshop, (6) factory or (7) manufacturing establishment situated in the United States (except only a boys' or girls' canning club duly recognized by a state agricultural department or United States agricultural department).[4]

Mill, Cannery, Workshop, Factory or Manufacturing Establishment. In the case of these establishments the tax applies if (a) any child between the ages of 14 and 16 (presumably both ages inclusive) has been employed or permitted to work more than eight hours in any day or more than six days in any week or before six o'clock a. m. or after seven o'clock p. m.; and (b) if any child under the age of fourteen has been employed or permitted to work at all.[5] The term "workshop, factory, or manufacturing establishment" includes bakeries, blacksmith shops,

[1] Revenue Act of 1921, Title XII; Revenue Act of 1918, Title XII.

[2] Revenue Act of 1918, § 1207.

[3] Reg. 46, Art. 5.

[4] Revenue Act of 1921, § 1200; Revenue Act of 1918, § 1200; Reg. 46, Art. 2.

[5] Revenue Act of 1921, § 1200; Revenue Act of 1918, § 1200; Reg. 46, Art. 3. The term "under the age of fourteen years" is meant to include all

boxmaking establishments, steam laundries, and stonecutting.[6] The term "manufacturing establishment" includes bottling plants, gas companies,[7] ice factories,[8] meat markets engaged in the manufacture of meats for local trade, newpaper publishing plants or companies,[9] timber cutting in woods and logging force operations connected with the operation of a manufacturing establishment.[10] The following are not included within these terms: drug store (retail) ; express companies; grocery stores (retail) ; mercantile stores not connected with taxable establishments; moving picture business, either in studio or out of doors; telegraph offices, in respect of boys and messengers; telephone companies; trust and title companies; tobacco plantations (cutting and stringing tobacco leaves) ; commissaries operated by sawmills.[11] Some additional rulings in particular industries are indicated below.

EMPLOYMENT IN GENERAL AND FACTORY OFFICES. The terms workshop, factory, or manufacturing establishment as used in the Child Labor Tax Law, clearly mean the premises on which

children who have not yet reached their fourteenth year. The term "eight hours in any day" means the actual period of employment and shall be reckoned from the time the child is required or allowed to be at the place of employment until he or she stops work for the day, exclusive of one continuous period of a definite length of time during which the child is off work and not subject to call for duty of any kind. The term "six days in any week" means six consecutive days, no one of which shall consist of more than eight hours of working time. A "day" must not begin before 6 o'clock a. m. and must not extend beyond 7 o'clock p. m. (Reg. 46, Art. 1.)

[6] Letters from treasury department dated June 14, 1919; April 1, 1919; June 9, 1919; and August 2, 1919, respectively.

[7] The employment of boys between 14 and 16 years to light and extinguish street lamps does not render a gas company subject to tax if their presence in and about the gas factory premises is not required or permitted.

[8] This ruling refers to the employment of boys to accompany delivery wagons and carry ice into houses.

[9] The employment of children in the distribution of papers outside and away from the manufacturing establishment does not come within the purview of the statute.

[10] Letters from treasury department dated May 28, 1919; May 21, 1919; April 12, 1919; May 5, 1919; and May 27, 1919, respectively.

[11] Letters from treasury department dated May 2, 1919; May 1, 1919; May 15, 1919; May 2, 1919; June 14, 1919; June 21, 1919; April 1, 1919; May 31, 1919; May 7, 1919; May 8, 1919; June 20, 1919; May 21, 1919. The presence of child employees of the company, however, in or about a sawmill premises contrary to the standards laid down by the statute would subject the person operating the mill to the tax.

the manufacturing business is conducted, including the buildings and grounds. The terms in their ordinary sense include whatever is necessary to carry on the mechanical operation or process. Any part essential to the conduct of a manufacturing business is as much a part of a manufacturing establishment as the buildings in which the machinery is housed, or the ground occupied by the buildings. A factory office, therefore, is a part of the establishment and no distinction can be made in employment in different departments. The duties of office employees frequently take them into and often require their presence in the plant or manufacturing part of such establishments when they are accessible. Actual employment in the manufacturing or production part of a plant is not necessary, and it is not possible to exempt from the application of the law any occupation or class of employment connected with the operation of the establishment specified. The law applies if children are employed in or about the establishment. An office which occupies the top floor of a factory building of a manufacturing and selling company would come within the application of the law, and if children under 14 years are employed, or if children between 14 and 16 years are permitted to work more than eight hours in any day or more than six days in any week, or before 6 a. m., or after 7 p. m., the person operating the establishment would be subject to the imposition of the tax. Office employees as a class and apart from the operation of the establishments specified are not believed to be within the taxation intent of the Child Labor Tax, and the provisions of this act do not apply to the employment of children in a general office, a main office, or district office established purely for office purposes, in no way a part of the manufacturing establishment as defined, but conducted solely as a city office whose employees under the age of 16 years are never required or permitted or suffered to be in or about the manufacturing establishment.[12]

AGRICULTURAL AND FORESTRY OPERATIONS. The statute does not apply to the agricultural industry, even though it may be part of a complete industrial cycle, or to forestry operations. A sugar mill and sugar-cane plantation may be operated as a unit, but the law does not apply to the labor employed in the production of the cane. The employment of children contrary to the terms of the law in or about the mills would subject the person operating the mill to the imposition of the tax, but employment

[12] Letters from treasury department dated May 31, 1919; May 2, 1919; and June 26, 1919.

or permission to work of children in the fields in purely farming or agricultural operations does not come within the taxation intent of the law.[13] But the snipping of beans or husking of corn for canning, even though carried on at some distance from the cannery proper, is an essential part of the business. Beans are snipped and corn husked as a necessary part of a canning operation and not a necessary part of an agricultural operation. Farming or agricultural work may cease and be complete with the production and picking or gathering of beans and corn, but when these vegetables are prepared and broken, snipped or husked, with a view to their immediate use in canning or preserving, for public sale, the snipping and husking, wherever carried on—in the fields, in sheds or shelters on the farm, in farm houses, or in sheds and shelters near the canneries—are a part of a cannery operation and the children employed on such work are employed in a cannery within the meaning of the law.[14] The employment of children in carrying on forestry operations in turpentine woods—such as distributing the "cups" or receptacles to catch the crude gum, or collecting the cups or receptacles, or dipping or removing the crude gum from the collecting receptacles and transferring it to buckets and thence to barrels, or raking dead leaves and rubbish away from the pine trees, or serving as water boys—occupations which are physically separate and wholly apart from the still or manufacturing establishment and from the character of the work would not permit the children to be in or about the still or manufacturing establishment, does not subject the employer to the tax.[15] The employment of children in the woods, as chain carriers for land surveyor and timber estimator, the nature of their employment never requiring or permitting their presence in or about the mechanical operations essential to the sawmill industry, does not come within the taxation intent of the law, and would not subject the person operating the sawmill to the tax.[16]

VACATION PERIOD. There is no exemption under the Child Labor Tax Law for the vacation period.[17]

CHILDREN IN COMPANY OF MOTHERS. The presence of any child in or about any of the establishments specified in the law

[13] Letters from treasury department dated April 12, 1919, and May 2, 1919.

[14] Letter from treasury department dated June 26, 1919.

[15] Letter from treasury department dated July 7, 1919.

[16] Letter from treasury department dated May 22, 1919.

[17] Letter from treasury department dated May 27, 1919.

will be taken as *prima facie* evidence of its employment therein. It is immaterial that the children are in or about the establishments with their mothers and are entirely too young to work or be of service there.[18]

Son of Proprietor. A tax is imposed on every person operating a mill, cannery, workshop, factory, or manufacturing establishment in which children under the age of 14 years are employed or permitted to work. No distinction can be made under the law in the matter of the owner's children.[19]

Janitor Service in Office of Manufacturing Plant. No distinction can be made in the kind of occupation or employment in any of the establishments specified in the Child Labor Tax Law. A factory office is a part of the factory, and where children under 14 years of age are employed to do sweeping and cleaning in the office of a manufacturing plant during any portion of the year, the person operating such establishment is subject to the tax imposed.[20]

Mine or Quarry. In the case of a mine or quarry, the tax applies if any child under the age of 16 years has been employed or permitted to work therein.[21]

In or About Mines. The term mining premises as applied to the Child Labor Tax Law is held to mean any property used in mining operations—that is, the mining lands in which the deposits of minerals are worked by ordinary mining processes—and is limited to the grounds and buildings used in the operation of the mine. The different departments of the mining premises, such as work on tipples, breakers, tracks, in mine office, carrying messages from department to department, hauling materials to and from the mines, or any other operation connected with the whole mode of obtaining metals or minerals for commercial purposes, come within the purview of the law. Stores and other enterprises outside and away from the mining operations, though owned and controlled by the mining company, are not considered necessary to carry on the mechanical operation or process of the mine and the provisions of Section 1200 relating to mines do not apply to the employment of children in such places, the character of the work never requiring or permitting their presence in or

[18] Letter from treasury department dated June 4, 1919.

[19] Letter from treasury department dated May 31, 1919.

[20] Letter from treasury department dated May 16, 1919.

[21] Revenue Act of 1921, § 1200; Revenue Act of 1918, § 1200; Reg. 46, Art 3. The term "under the age of sixteen years" is meant to include all children who have not yet reached their sixteenth year. (Reg. 46, Art. 1.)

about the mines. Making of mine props and cutting of ties or the manufacture of other material purchased for use in a mine is not part of the mining process and the law relating to employment of children in mines would not apply. If, however, such work is done in connection with the operation of a sawmill or lumber mill, or other manufacturing establishment, the law pertaining to mills and manufacturing establishments would apply. If the grading of a road takes a child employee under 16 years in or about a mine, the person operating the mine will be liable to the tax. If the work of grading a road does not require the child to be in or about the mine, his employment will not subject the mine operator to the tax. The tax is not imposed on the employment of children at road grading, nor is it imposed on a mining company for employment of children under 16 everywhere, but it is imposed upon the mine operator if children under 16 years are employed in or about the mines.[22]

COKE OVENS. A coke plant is not considered a part of a mining industry but is held to be a manufacturing establishment within the meaning of the law.[23]

Time (Sun or Clock). The Act of Congress approved March 19, 1918, entitled "An act to save daylight and to provide standard time for the United States," provides that "In all statutes * * * relating to time * * * within which any act shall or shall not be performed by any person subject to the jurisdiction of the United States, it shall be understood and intended that the time shall be the United States standard time of the zone within which the act is to be performed." The standard of hours relating to the employment of children must be determined in accordance with the provisions of the law on this point, and the United States standard time of the zone in which a mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment is located will govern in the enforcement of the Child Labor Tax law.[24]

Duration of Employment. Liability for the tax is established by the employment of any child laborer. The product of the child's labor is not the basis for the imposition of the tax. The tax is applied to the entire net income of the taxable establishment.[25] Employment contrary to the provisions of the act for a

[22] Letter from treasury department dated August 2, 1919.

[23] Letter from treasury department dated June 21, 1919.

[24] Letter from treasury department dated May 2, 1919.

[25] Reg. 46, Art. 3.

single day is sufficient to impose the tax on the net profits for the whole taxable year.[26]

Certificate of Age. Any person subject to the provision of the law who in good faith obtains a certificate at the time of employment showing the child to be of such age as not to come within the purview of the law, and keeps such certificate on file, may rely in good faith on such certificate to relieve him from the tax. Such certificate is to be issued in such form, under such conditions, and by such persons as may be prescribed by a board composed of the Secretary of the Treasury, the Commissioner of Internal Revenue and the Secretary of Labor. The board may also authorize the use of employment certificates or other similar papers as to the age of the child issued under the laws of any state designated by the board.[27] This board has prescribed the following regulations: Certificates of age, in order to free from liability to taxation persons operating the business specified, shall be either: (a) Federal age certificates for children between 14 and 16 years of age when employed or permitted to work in any mill, cannery, workshop, factory, or manufacturing establishment, and for children between 16 and 17 years of age when employed or permitted to work in or about any mine or quarry. Such certificates shall bear (1) the child's name; (2) birthplace; (3) month, day, and year of birth; (4) color; (5) sex; (6) kind of evidence of age accepted and age when physical age is accepted; (7) signature of the child; (8) name and address of child's parents, guardian, or custodian; (9) name and address of employer; (10) signature, address, and official designation of agent issuing the certificate; (11) date and place certificate was issued. (b) An age certificate, working or employment certificate or permit, or other similar paper as to the age of the child, issued in accordance with the laws of the state in such states as are designated by the board.[28]

Proof of Age. Age-certificate inspectors authorized to issue federal certificates of age shall do so only after securing, examining, and approving proof of age as follows: The child shall make application to the age-certificate inspectors in person, accompanied by parent, guardian or custodian, with documentary evidence of age, showing that he is 14 years of age or over if the employment is to be in a mill, cannery, workshop, factory, or

[26] See Revenue Act of 1921, §§ 1200 and 1207; Revenue Act of 1918, §§ 1200 and 1207.

[27] Revenue Act of 1921, § 1203 (a); Revenue Act of 1918, § 1203 (a).

[28] Reg. 46, Art. 8.

manufacturing establishment, or that he is between 16 and 17 years of age if employment is sought in or about a mine or quarry. Documentary evidence of proof of age, required in the order following, shall be: (a) A birth certificate or duly attested transcript thereof issued by the registrar of vital statistics or other officer charged with the duty of recording births. (b) A baptismal certificate or transcript of the record of baptism, duly certified, showing the date of birth and place of baptism of child. (c) A *bona fide contemporary* record of the date of the child's birth, comprising a part of the family record of births in the Bible, or other documentary evidence satisfactory to the board, such as a certificate of arrival in the United States issued by the United States immigration officers and showing the age of the child, a passport showing the age of the child, or a life insurance policy: Provided, that such other satisfactory documentary evidence has been in existence at least one year, and in the case of a life insurance policy at least four years; And provided further, that a school record or a parent's, guardian's, or custodian's affidavit or other written statement of age shall not be accepted except as specified in paragraph (d). (d) A certificate signed by a public-health physician or a public-school physician, stating, in his opinion, the physical age of the child. Such certificate shall show the height and weight of the child and other evidence of physical age revealed by the physician's examination or upon which the opinion of the physician is based. A parent's, guardian's, or custodian's signed statement as to the age of the child, and a record of age as given on the register of the school first attended by the child, or in any school census, if obtainable, shall be submitted with the physician's certificate showing physical age. No certificate shall be issued if the physician's certificate of physical age or the parent's statement or the register of the school first attended or the school census shows the child to be under the age of 14 if employment in a mill, cannery, workshop, factory, or manufacturing establishment is contemplated, or under the age of 16 if employment in a mine or quarry is contemplated. The agent issuing the age certificate for a child shall require the evidence of age stated in paragraph (a) in preference to that specified in any subsequent paragraph, and shall not accept evidence of age permitted by any later paragraph unless he shall receive and file evidence that the proof of age required by the preceding paragraph or paragraphs can not be obtained.[29]

[29] Reg. 46, Art. 9.

Acceptance of State Certificates. States in which age certificates, or working or employment certificates, permits or other similar papers as to the age of the child are issued under state authority, substantially in accord with the requirements of this act and these regulations may be designated as states in which such certificates have the same force and effect as federal age certificates, *except as the acceptance for the purposes of the statute of individual certificates may be suspended or revoked.* Certificates, permits, or other similar papers in states so designated shall have the same effect as federal age certificates so long as they shall remain in force, the Commissioner or such person as he may designate possessing the right to suspend or revoke the acceptance for the purposes of this act of individual certificates at any time. Certificates imposing restrictions or conditions in addition to the requirements of the federal law or of the regulations shall not be held inconsistent with the law.[30]

Mistakes as to Age of Child. If a child has been employed or permitted to work under a mistake of fact as to the age of such child, and without intention to evade the tax, such employment will not cause the tax to be imposed.[31]

Inspection of Establishment. The Commissioner, or any person authorized by him, may enter and inspect at any time any mine, quarry, mill, cannery, workshop, factory or manufacturing establishment. The Secretary of Labor, or any person duly authorized by him, has like authority to make inspections for the purpose of complying with a request of the Commissioner.[32]

Basis and Rate of Tax. The statute imposes an excise tax which is in addition to all other taxes imposed by law at the rate of 10% on the entire net profits received or accrued during any taxable year in which child labor is employed for any period of time, as indicated in the law. The net profits are computed by deducting from the gross amount received or accrued during the taxable year from the sale or disposition of such products manufactured within the United States (a) the cost of raw materials entering into the production; (b) running expenses, including rentals, repairs, maintenance, heat, power, insurance, management and a reasonable allowance for salaries and depreciation; (c) interest on money borrowed and used to meet the needs of the business; (d) taxes of all kinds paid during the taxable year with respect to the business or property relating to the produc-

[30] Reg. 46, Art. 10.

[31] Revenue Act of 1921, § 1203 (b); Revenue Act of 1918, § 1203 (b).

[32] Revenue Act of 1921, § 1206; Revenue Act of 1918, § 1206.

tion and (e) losses actually sustained within the taxable year in connection with the business of producing such products, including losses from fire, flood, storm or other casualties, not compensated for by insurance or otherwise. If the product is sold at less than the fair market price in such manner as to directly or indirectly benefit any person directly or indirectly interested in the business or with intent to cause such benefit, the tax is imposed on the gross amount received or accrued from the sale or disposition during the period that any such sales took place.[33]

Returns to Be Filed. Every person subject to the provisions of the law (which seems to mean those who operate establishments of the kind enumerated in the law) is required to file a return annually showing the gross amount of income received or accrued during the year from the sale or disposition of the product of any mine, quarry, mill, cannery, workshop, factory or manufacturing establishment in which children have been employed subjecting him to the tax and the amounts allowed by the law to be deducted therefrom, and other particulars, in such form as the Commissioner may require. Such returns are to be filed on or before the first day of the third month following the close of each taxable year, with the local collector. Extension of time to file returns may be granted by the collector in case of sickness or absence.[34]

Tax Due. The collector transmits forthwith all returns to the Commissioner, "who shall, as soon as practicable, assess the tax found due and notify the person making such returns of the amount of tax for which such person is liable, and such person shall pay the tax to the collector on or before 30 days from the date of such notice."[35]

Time Record. A time record should be kept daily by persons operating any mill, cannery, workshop, factory, or manufacturing establishment, showing the hours of employment for each and every child who has completed the fourteenth year but has not yet completed the sixteenth year of its age, whether employed on a time or a piece rate basis. Certificates of age for children employed in any mill, cannery, workshop, factory, or manufacturing establishment may be suspended or revoked for

[33] Revenue Act of 1921, §§ 1200, 1201 and 1202; Revenue Act of 1918, §§ 1200, 1201 and 1202; Reg. 46, Art. 3.

[34] Revenue Act of 1921, § 1204; Revenue Act of 1918, § 1204; R. S., § 3176, as amended; Reg. 46, Art. 4.

[35] Revenue Act of 1921, § 1205; Revenue Act of 1918, § 1205; Reg. 46, Art. 6.

failure on the part of the person operating the same to keep time records as required by this regulation or for false or fraudulent entries made therein.[36]

Penalties. The general penalties apply for failure to file returns, or pay the tax, or for filing false or fraudulent returns.[37] Refusal to permit entry or inspection of any establishment is punished by fine of not more than $1,000 or imprisonment for not more than one year, or both fine and imprisonment.[38] Any person who knowingly makes a false statement or presents false evidence in or in relation to any certificate of age or application therefor will be subject to a fine of not less than $100 nor more than $1,000, or to imprisonment for not more than three months, or to both such fine and imprisonment.[39] Actions to enforce these penalties will be brought in the federal courts by the United States district attorney of the federal judicial district in which the offense occurs.[40]

Constitutionality of Child Labor Tax. The Supreme Court of the United States has declared unconstitutional the so-called Child Labor Law, which prohibited the transmission in interstate commerce of products of child labor.[41] The present excise tax equivalent to 10% of the net profits received from the sale of products of establishments employing child labor is intended to accomplish the same object which the former law was unable to reach.[42]

[36] Reg. 46, Art. 11.

[37] See Revenue Act of 1918, §§ 1308 and 1317, containing R. S., § 3176, as amended and re-enacted without change by Revenue Act of 1921, § 1311.

[38] Revenue Act of 1921, § 1206; Revenue Act of 1918, § 1206.

[39] Revenue Act of 1921, § 1203; Revenue Act of 1918, § 1203.

[40] Reg. 46, Art. 7.

[41] Hammer v. Dagenhart, 247 U. S. 251. The Supreme Court was considerably divided in this decision. Mr. Justice Day delivered the majority opinion which was concurred in by Mr. Justice Van Devanter, Mr. Justice Pitney, Mr. Justice McReynolds and Chief Justice White. Mr. Justice Holmes delivered a dissenting opinion which was concurred in by Mr. Justice McKenna, Mr. Justice Brandeis and Mr. Justice Clarke.

[42] It has been decided by a federal district court (Atherton Mills v. Johnston) that the child labor title of the Revenue Act of 1918 is also unconstitutional and this case is now No. 16 on the docket of the United States Supreme Court. Another case, Bailey v. Drexel Furniture Co., is also before the Supreme Court for decision on this point.

CHAPTER 47

CONSTRUCTION OF TAXING STATUTES

It is beyond the scope of this chapter to discuss at great length the numerous rules of statutory construction. The following paragraphs will indicate briefly rules especially applicable to revenue statutes which may be of assistance in the interpretation of such ambiguities as are encountered in our present system of income, excess-profits and other tax laws. Wherever possible the citation of authorities has been confined to cases arising under various revenue laws of the United States.

Although a statute may be construed contrary to its literal meaning when a literal construction would result in an absurdity, inconsistency, or in glaring inequality, and palpable injustice, where its language is susceptible of more reasonable, though perhaps less natural, construction which carries out its spirit rather than letter,[1] it is a well-settled general rule that a legislative act must be interpreted according to the intention of the legislature apparent upon its face.[2] Construction and interpretation have no place where the language of a statute is unambiguous and its meaning evident.[3] Arguments as to the expediency of a tax law or the possible economic mistake or wrong involved in the tax imposed thereby [4] or the inequality thereof,[5] are beyond judicial cognizance.[6] To ascertain the intention of the legislature the first resort is to the grammatical sense and the natural,

[1] Stratton's Independence v. Howbert, 231 U. S. 399; Knowlton v. Moore, 178 U. S. 41, 77; Treat v. White, 181 U. S. 264; Sesnon Co. v. U. S., 182 Fed. 573, writ of certiorari denied 220 U. S. 609.

[2] Wilkinson v. Leland, 2 Pet. 627; U. S. v. Union Pacific R. R. Co., 91 U. S. 72; Sol. Op. 83, T. B. 3-21-1402.

[3] U. S. v. Ninety-Nine Diamonds, 139 Fed. 961, writ of certiorari denied 201 U. S. 645.

[4] Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Blunt v. U. S., 255 Fed. 332.

[5] LaBelle Iron Works v. U. S., 41 Sup. Ct. Rep. 528; 65 L. ed. 604; Billings v. U. S., 232 U. S. 261, 255 Fed. 332.

[6] In income tax cases, 148 Wis. 456, 134 N. W. 673, 135 N. W. 164, the court said: "With the political or economic policy or expediency of the law we have nothing to do. If it be within constitutional lines, it represents and embodies public policy, because it is enacted by that branch of the government which determines public policy." See State ex rel. Wisconsin Trust Company v. Widule, 164 Wis. 56.

ordinary and familiar meaning of the words employed,[7] and it is particularly true that terms used in statutes describing objects of taxation should be construed according to the popular acceptation of the terms they employ rather than by refined or strained analogies.[8] The presumption is that language has been employed with sufficient precision to disclose the intention of the legislature and unless this presumption is overthrown, nothing remains but to enforce the statute as written.[9] If, however, it is apparent on the face of the statute, or from its context, that a term of common use and meaning is intended to bear some other signification, it may be interpreted accordingly.[10] For instance, it is the duty of those construing a statute to give effect to the clear intention of those passing it, and to do this it is common practice to read the words "and" and "or" convertibly.[11] The word "false" may be construed to mean either incorrect but in good faith[12] or incorrect with fraudulent intent.[13] Words having a fixed legal meaning are presumed to have been used in such sense.[14] Commercial and trade terms, which belong exclusively to the vocabulary of merchants and traders or which are shown to have a certain, uniform and general meaning in commerce and trade different from their ordinary meaning, will be interpreted accordingly.[15] Generally, a descriptive trade term used in the act will be given the special meaning attaching to it at the time the act was passed,[16] but in some cases a later and broader meaning may be adopted if warranted by commercial usage and the general lan-

7 Treat v. White, 181 U. S. 264; Columbia Water Co. v. Columbia Co., 172 U. S. 475; Mallard v. Lawrence, 16 How. 251; Schriefer v. Wood, 21 Fed. Cas. No. 12,481; U. S. v. Isham, 17 Wall. 496; U. S. v. Chesbrough, 176 Fed. 778; Seldon v. Equitable Trust Co., 8 Fed. Cas. No. 4,508, affirmed 94 U. S. 419.

8 Nix v. Hedden, 39 Fed. 109, affirmed 149 U. S. 304; De Ganay v. Lederer, 239 Fed. 568.

9 Mannington v. Hocking Valley R. R. Co., 183 Fed. 133.

10 U. S. v. Chesbrough, 176 Fed. 778.

11 U. S. v. Fisk, 3 Wall. 445. But the word "and" is never construed to mean "or" in the absence of cogent reasons for so doing. (Rice v. U. S., 53 Fed. 910.)

12 National Bank of Commerce v. Allen, 223 Fed. 472; Eliot National Bank v. Gill, 218 Fed. 600.

13 U. S. v. Ninety-Nine Diamonds, 139 Fed. 961.

14 U. S. v. Fidelity Trust Co., 222 U. S. 158; Nat. Life & Accident Ins. Co. v. Craig, 251 Fed. 524.

15 Maddock v. Magone, 152 U. S. 368; Sonn v. Magone, 159 U. S. 417.

16 Dennison Mfg. Co. v. U. S., 72 Fed. 258; Rossman v. Hedden, 145 U. S. 561; Hedden v. Richard, 149 U. S. 346; Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

guage of the statute.[17] General terms following special terms are, as a rule, limited in scope and meaning to the same general class as the special terms; in other words, the particular words are presumed to describe certain species and the general words to be used to include other species of the same genus.[18] But this is only a rule of construction to aid in arriving at the real legislative intent. It is not a cast-iron rule, overriding all other rules of construction, and it will never be applied to defeat the real purpose of the statute as gathered from its entire context. While the rule is aimed to preserve a meaning for the particular words, it should not be permitted to render meaningless the general words. Therefore, where the particular words exhaust the class, the general words must be construed as embracing something outside of that class. If the particular words exhaust the class, there is nothing *ejusdem generis* left, and in such case the general words must be given the meaning outside of the class indicated by the particular words, otherwise the meaning of the general words would be sacrificed to preserve the particular words and the rule would defeat its own purpose.[19] The general rule of construction applicable to all statutes and written instruments that words should be given the meaning naturally attaching to them from their context and that a word of obscure meaning, taken by itself, may be construed by reference to associated words, is applicable to the construction of revenue laws.[20] Effect should be given, if possible, to the entire statute, and part should not be permitted to perish by construction. One part should not be allowed to defeat another part, if by any reasonable construction the two can stand together.[21] If the context of the statute is ambiguous, the title,[22] preamble,[23] and punctuation,[24] may be considered, but they are seldom the subject of special consideration by the legislature and are fallible and unreliable guides

[17] Pickhardt v. Merritt, 132 U. S. 252; Newman v. Arthur, 109 U. S. 132.

[18] U. S. v. 1,150½ pounds of Celluloid, 82 Fed. 627; Reiche v. Smythe, 13 Wall. 162; U. S. v. Weise, 28 Fed. Cas. No. 16,659.

[19] U. S. v. Mescall, 215 U. S. 26.

[20] Marsching v. U. S., 113 Fed. 1006; U. S. v. Sixty-Five Terra Cotta Vases, 18 Fed. 508, 510; Patton v. U. S., 159 U. S. 500, 509; Adams v. Bancroft, 1 Fed. Cas. No. 44; Taber v. U. S., 23 Fed. Cas. No. 13,722.

[21] U. S. v. Ninety-Nine Diamonds, 139 Fed. 961; State ex rel. Arpin v. Eberhardt, 158 Wis. 20; Sol. Op. 90, T. B. 7-21-1432.

[22] Knowlton v. Moore, 178 U. S. 41; Smythe v. Fiske, 23 Wall. 374; Church of Holy Trinity v. U. S., 143 U. S. 457; Hedden v. Collector, 5 Wall. 107; Cornell v. Coyne, 192 U. S. 418.

[23] Price v. Forrest, 173 U. S. 410, 427.

[24] U. S. v. Isham, 17 Wall. 496; U. S. v. Three Railroad Cars, 28 Fed. Cas. No. 16,513; Ford v. Delta Co., 164 U. S. 662.

in ascertaining the intention of that body.[25] While the rule is that taxing statutes should be so construed as to prevent them from operating retroactively,[26] that is merely a principle of construction and the courts will not save a statute from producing a retroactive effect, if the intent that it should so operate is clear.[27]

Construction Which Will Be Constitutional. It is a well-established rule that when a statute admits of two interpretations, one of which presses it beyond constitutionality and the other of which brings it within constitutionality or avoids the question of constitutionality, the courts tend to adopt the latter interpretation.[28] The foundation of this rule, it is to be noted, is the possibility of two constructions, and the existence of grave doubt as to constitutionality. Where the doubt is not grave the courts will give the statute the most natural meaning resulting from its text, as otherwise the mere assertion that a statute is unconstitutional would tend to set aside the general rules of construction.[29]

Proceedings in Congress as Aid to Construction. Notwithstanding the well-established rule that the intent of the lawmakers is to be found in the statutes they pass, the courts, where the language of a statute is ambiguous and its meaning doubtful, should not shut their eyes to what can be learned of the history of the times and of the law, of the condition of the law at a particular time, the mischief or evil sought to be remedied, and other kindred things which would put them in the light that the lawmakers enjoyed and enable them to view the situation as it appeared to those who passed the act.[30] The legislative history of a subsequent statute will not be considered as an aid to construction.[31] For such purposes, in interpreting ambiguous stat-

[25] State ex rel. Arpvin v. Eberhardt, 158 Wis. 20.

[26] Stockdale v. Insurance Co., 20 Wall. 323; Lynch v. Turrish, 247 U. S. 221.

[27] Billings v. U. S., 232 U. S. 261.

[28] Stratton's Independence v. Howbert, 231 U. S. 399; Singer Mfg. Co. v. McCollock, 24 Fed. 667.

[29] U. S. v. Bennett, 232 U. S. 299.

[30] U. S. v. Standard Oil Co., 221 U. S. 1; U. S. v. Trans-Missouri Freight Association, 166 U. S. 290, 318; Holy Trinity Church v. U. S., 143 U. S. 457, 463; Jennison v. Kirk, 98 U. S. 453; Carbon Steel Co. v. Lewellyn, 258 Fed. 533; Northern Commercial Co. v. U. S., 217 Fed. 33; LaBelle Iron Works v. U. S., 41 Sup. Ct. Rep. 528; 65 L. ed. 604; Ho Ah Kow v. Nunan, 5 Sawy 552; Peo. v. Charles Schweinler Press, 214 N. Y. 395; Woollcott v. Shubert, 217 N. Y. 212, 111 N. E. 829.

[31] Penn Mutual Life Insurance Co. v. Lederer, 252 U. S. 523.

utes, the formal reports of committees having in charge a pending legislative bill including the bill as introduced, changes made in the frame of the bill in the course of its passage, and statements made by the committee chairman in charge of it may, under proper qualifications, be referred to as bearing upon questions of legislative intent.[32] Courts take judicial notice of legislative journals and proceedings in congress so far as they are admissible in aid of statutory construction.[33] But individual statements made in debate do not necessarily reflect the intent and understanding of the legislative body and are unreliable as an aid to construction, as many individual members may remain silent and may vote for a bill because in their judgment it has a wider or narrower scope than its author states.[34] Accordingly the courts may not, in interpreting a statute, recur to the motives of individual members of the legislative body nor to what they supposed the bill to mean.[35] Such individual statements may, however, be resorted to as a means of ascertaining the environment at the time of enactment of a particular law, that is, the history of the period when it was adopted.[36]

[32] U. S. v. St. Paul M. & M. R. Co., 247 U. S. 310, 318; Caminetti v. U. S., 242 U. S. 470, 490; Lapina v. Williams, 232 U. S. 78; Woodward v. DeGraffenried, 238 U. S. 284; Pennsylvania R. Co. v. International Coal Min. Co., 230 U. S. 184; McLean v. U. S., 226 U. S. 374; Shallus v. U. S., 162 Fed. 653; Mosle v. Bidwell, 130 Fed. 334; Matter of Hamlin, 226 N. Y. 407, 414.

[33] Connole v. Norfolk & Western Ry. Co., 216 Fed. 823; Wadsworth v. Boysen, 148 Fed. 771. In Atlantic C. L. R. Co. v. Riverside Mills, 219 U. S. 196, 200, the court in construing the Carmack amendment quotes a speech of Judge William Richardson, a congressman from Alabama, made when the amendment was reported by a conference committee. Judge Richardson was speaking for the committee of the matter which it was sought to remedy.

[34] Sweetser v. Emerson, 236 Fed. 161; Johnson v. U. S., 215 Fed. 679; U. S. v. Trans-Missouri Freight Association, 166 U. S. 290, 318; Mitchell v. Great Works Milling, etc. Co., 2 Story 653; McKenzie v. Hare, 239 U. S. 299.

[35] U. S. v. Union Pacific R. R. Co., 91 U. S. 72; Omaha & C. B. Street R. Co. v. Interstate Commerce Commission, 230 U. S. 324; Pennsylvania R. R. Co. v. International Coal Mining Co., 230 U. S. 184; Aldridge v. Williams, 3 How. 23.

[36] Standard Oil Co. v. U. S., 221 U. S. 1; Jennison v. Kirk, 98 U. S. 453, 459; Central Building, Loan & Savings Co. v. Bowland, 216 Fed. 526. It is difficult to reconcile the authorities on the question of the admissibility of individual statements in debate in interpreting a statute. There are cases such as Roberts v. Southern Pacific Co., 186 Fed. 934, affirmed 219 Fed. 1022, which consider such statements for more extended purposes than are permitted under the Standard Oil Co. and St. Paul M. & M. R. Co. cases

Effect of Rulings and Practice of Treasury Department. Great weight and due deference and respect is always given by the courts to the construction put upon a revenue statute by the treasury department.[37] This rule also applies to the construction of state statutes by the highest state authorities charged with the duty of administration, when the meaning of such state statutes is at issue in the federal courts.[38] Where the language of a statute is dubious and open to different interpretations the construction of the treasury department is in the highest degree persuasive, if not controlling, in its effect upon the courts, and is not to be disregarded without the most cogent reasons if it has been followed for many years without any attempt on the part of congress to change it and where there has been a long acquiescence in it, and especially if by it the rights of parties for many years have been determined and adjusted.[39] But the construction of the treasury department cannot repeal a statute; it can only be resorted to in aid of interpretation, and is not applicable to what has no need of interpretation. It is therefore inadmissible and immaterial where the language of the statute is clear and precise or where it will not bear the interpretation put upon it by the department.[40]

Construction by Reference to Similar Statutes. As a general rule, where a statute is of doubtful meaning and susceptible on its face of two constructions,[41] the court may look into prior acts to determine its proper construction.[42] This rule has been repeat-

and the authorities heretofore cited, but they seem contrary to the weight of authority.

[37] U. S. v. Cerecedo Hermanos y Compania, 209 U. S. 338; De Ganay v. Lederer, 239 Fed. 568; affirmed 250 U. S. 376; Smythe v. Fiske, 23 Wall. 374; Edwards v. Wabash Ry. Co., 264 Fed. 610; La Belle Iron Works v. U. S., decided June 28, 1920, Ct. Cls. No. 34603; T. D. 3051, T. B. 34-20-1158; 41 Sup. Ct. Rep. 528; 65 L. ed. 604.

[38] Maryland Casualty Co. v. U. S., 251 U. S. 342; Insurance Co. of North America v. McCoach, 218 Fed. 905, reversed 224 Fed. 657, 661, writ of certiorari granted 241 U. S. 694, reversed 244 U. S. 585. See opinion of Circuit Court of Appeals. In reversing this court the Supreme Court conceded full effect to the administrative or executive construction followed, but held that it did not answer the decisive question involved.

[39] U. S. v. Johnson, 124 U. S. 236; Robertson v. Downing, 127 U. S. 607; Van Dyke v. Milwaukee, (Wis.) 146 N. W. 812; see rehearing 150 N. W. 509; Galm v. U. S., 39 Ct. Cls. 55; L. O. 1060, T. B. 14-21-1554.

[40] Swift Company v. U. S., 105 U. S. 691; Merritt v. Cameron, 137 U. S. 542; U. S. v. Graham, 110 U. S. 219; U. S. v. Tanner, 147 U. S. 661; Cryan v. Wardell, 263 Fed. 248.

[41] Bate Refrigerator Co. v. Sulzberger, 157 U. S. 1.

[42] Hamilton v. Rathbone, 175 U. S. 414; Connecticut General Life Ins. Co. v. Eaton, 218 Fed. 188.

edly applied in the construction of the Revised Statutes of the United States.[43] It is particularly applicable to revenue legislation and absolutely necessary in the case of the legislation of congress on this subject, for without it the revenue could not be collected and inextricable embarrassments and difficulties would constantly occur.[44] The revenue laws, though made up of independent enactments, are regarded as constituting practically one system,[45] and to ascertain the legislative intent courts not only search all the provisions of the particular revenue statutes in question, but look beyond those to others *in pari materia*, or of a similar purport, which compose the system.[46] Any rule of construction, separating from this revenue system, and its component numerous and diverse enactments, each new act altering it, would be unsound and unsafe.[47] When congress re-enacts without change a statute which has previously received a construction by the federal supreme court, it will be deemed to have adopted such construction,[48] and an executive or departmental construction of an earlier act will also be sanctioned by subsequent re-enactments,[49] especially where the executive or depart-

[43] Hamilton v. Rathbone, 175 U. S. 414; U. S. v. Hirsch, 100 U. S. 33; U. S. v. Bowen, 100 U. S. 508; U. S. v. Sixty-Five Terra Cotta Vases, 18 Fed. 508.

[44] Stuart v. Maxwell, 16 How. 160.

[45] In re Southern Pacific Co., 82 Fed. 311, affirmed 87 Fed. 863.

[46] Smietanka v. Zibell, U. S. C. C. A., 7th Circ. T. D. 3000, T. B. 15-20-857; U. S. v. Collier, 25 Fed. Cas. No. 14,833.

[47] Saxonville Mills v. Russell, 116 U. S. 21.

[48] Latimer v. U. S., 223 U. S. 501.

[49] U. S. v. Cerecedo Hermanos y Compania, 209 U. S. 338; U. S. v. Falk & Bro., 204 U. S. 143, 152; Komada v. U. S., 215 U. S. 392; Wabash Valley Co. v. Edwards, 264 Fed. 152, 610. In the last mentioned case the court said: "Irrespective of original considerations, it is now too late for the department to change and by a novel ruling to alter a long settled interpretation of language taken from former acts of congress and thus to subject the issuance of stock under conversion privilege created prior to the passage of the present Act to an unexpected tax. All this could have been done by congress if language had been used specifically calling for such a result, but it can not be accomplished by the mere use of general terms which because of the repeated rulings of the department do not have the meaning to the business community now sought to be placed upon them. It is, of course, for the very purpose of making men's rights clearly understood, that the courts have held that long settled constructions of phrases by courts or governmental departments are to be read into statutes relating to kindred subject-matters. The present case is one where this doctrine seems eminently reasonable and just."

mental construction has been repeated and long continued [50] and where valuable property rights have been founded thereon.[51]

Similar Statutes in Other Jurisdiction. When a statute is adopted by another state or by congress, the construction previously given to such a statute by the highest court of the state from which it is adopted presumably becomes an integral part of and is incorporated into the law so adopted.[52] This is but a narrower application of the general principle that the language of an act is used, and so is to be interpreted, according to its legal significance at the time the act is passed.[53] The rule applies only to the construction followed in the state from which the statute is originally adopted and not to that followed in the state from which the statute is immediately taken,[54] and applies also primarily to decisions in force at the time of adoption. The courts will, however, treat subsequent decisions with respect.[55] But the rule that the courts of one state will deem the interpretative decisions of another state a part of a statute adopted from that state is not an absolute one, to be followed under all circumstances. It will not be followed where the construction urged to be adopted is contrary to the obvious meaning of the statute to be construed[56] or would make the statute unconstitutional in the state of adoption.[57]

Strict or Liberal Construction. The authorities upon the question of whether a taxing statute should be strictly or liberally construed, or whether it should be construed according to some medium between these two extremes, are in some confusion and no broad general rule can be safely stated. Excluding the construction of tax exemptions, which will be treated hereafter, three general lines of authority can be traced. One line of cases[58]

[50] U. S. v. Baruch, 223 U. S. 191; Wabash Railway Co. v. Edwards, 264 Fed. 610.

[51] Swigart v. Baker, 229 U. S. 187.

[52] Mustard v. Elwood, 223 Fed. 225; Robinson v. Belt, 187 U. S. 41; McDonald v. Hovey, 110 U. S. 619; Interstate Commerce Commission v. D. L. & W. R. Co., 220 U. S. 235.

[53] Commercial Travellers Ass'n v. Rodway, 235 Fed. 370, 374.

[54] Coulan v. Doull, 133 U. S. 216.

[55] Cathcart v. Robinson, 5 Pet. 264.

[56] Whitney v. Fox, 166 U. S. 637.

[57] In re. Swearinger, 23 Fed. Cas. No. 13,683.

[58] U. S. v. Wigglesworth, 2 Story 369, 28 Fed. Cas. No. 16,690; U. S. v. Isham, 17 Wall. 504; U. S. v. Watts, 28 Fed. Cas. No. 16,653; Equitable Trust Co. v. Seldon, 8 Fed. Cas. No. 4,507; Osgood v. Tax Commissioner, 235 Mass. 88, 126 N. E. 371. The court said in Powers v. Barney, 5 Blatch. 202, "Duties are never imposed on the citizens upon vague or doubtful interpretations." There are early cases holding to the contrary such as

holds that, as stated by the court in a leading case:[59] "In the first place, it is, as I conceive, a general rule in the interpretation of all statutes, levying taxes or duties upon subjects or citizens, not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters, not specifically pointed out, although standing upon a close analogy. In every case, therefore, of doubt, such statutes are construed most strongly against the government, and in favor of the subjects or citizens, because burdens are not to be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import. Revenue statutes are in no just sense either remedial laws or laws founded upon any permanent public policy, and, therefore, are not to be liberally construed." Since this decision it has been repeatedly held by the United States Supreme Court and the inferior federal courts that the provisions of a tariff act should be liberally construed in favor of the importer, and that in case of fair doubt as to the construction of a provision in such acts the courts should resolve the doubt in favor of the importer and that in such cases the intention of congress to impose a higher duty should be expressed in clear and unambiguous language.[60] And the same rule has been applied in the construction of other revenue laws,[61] including the

U. S. v. Olney, 27 Fed. Cas. No. 15,918, where a statue imposing a license fee for lottery dealers was being construed and the court said: "A revenue law is not to be strictly construed, but rather the contrary, so as to attain the ends for which it was enacted." See Twenty-Eight Cases, 2 Ben. 63; Rankin v. Hoyt, 4 How. 327; Smythe v. Fiske, 23 Wall. 374, 380.

[59] U. S. v. Wigglesworth, 2 Story 369, 28 Fed. Cas. No. 16,690.

[60] Benzinger v. U. S. 192 U. S. 38; American Net & Twine Co. v. Worthington, 141 U. S. 468; Shallus v. U. S., 162 Fed. 653; U. S. v. Tiffany, 160 Fed. 408; Hayes v. U. S., 150 Fed. 63; Hempstead v. Thomas, 122 Fed. 538; U. S. v. Merck & Co., 91 Fed. 639, affirmed 97 Fed. 989; Rice v. U. S., 53 Fed. 910. It has been said that the rule which gives the importer the benefit of a doubt is limited to cases where it relieves all importers of all articles whatsoever of the class concerned; that it probably has no practical use except in cases of extraordinary doubt; that it has a more appropriate application when the question is one of any tax at all; and that the federal reports are full of suits where the courts have not hesitated to perform the duty of determining mere questions of classification where it was admitted some duty was to be imposed, in favor of a higher rate, under circumstances of great difficulty. (U. S. v. Wetherell, 65 Fed. 987.)

[61] Eidman v. Martinez, 184 U. S. 578; Treat v. White, 181 U. S. 264; Gill v. Bartlett, 224 Fed. 927; Rockefeller v. O'Brien, 224 Fed. 541, affirmed 239 Fed. 127; Disston v. McClain, 147 Fed. 114; Wright v. Michigan Central R. Co., 130 Fed. 843; McNally v. Field, 119 Fed. 445; Treat v. Tolman, 113 Fed. 892.

1909 Law,[62] the 1913 Law, the 1916 Law, and the 1917 Stamp Tax Act,[63] and the 1916 Federal Estate Tax, as amended.[64] In a comparatively late case construing the war revenue act of June 13, 1898, imposing a special excise tax on sugar the Supreme Court, adopting the language of the dissenting opinion in the court below, held that where the construction of a tax law is doubtful, the doubt is to be resolved in favor of those upon whom the tax is sought to be laid.[65] And in a very recent case [66] arising under the 1913 Law in the Supreme Court, the rule quoted above was restated as an established rule of construction. Three recent cases in the lower federal courts have also stated generally with particular reference to the 1909 Corporation Excise Tax Law that revenue laws should be strictly construed against the government,[67] and it has been held that this rule applies especially where they impose burdens of a special or unusual character.[68] A second line of cases holds that revenue laws are not to be strictly construed in favor of the subject and against the state, but still with reasonable fairness to the citizen. It is stated in U. S. v. Distilled Spirits: [69] "In construing a severe statute, declaring a heavy forfeiture, (and, according to one construction claimed, for small offenses,) it is just to say, that those who are called upon to conduct their business affairs in view of all its provisions, ought to be fairly apprised of its requirements, and of its penalties, of whatever kind. They are bound to know the law, but lawmakers owe to them the duty to make the law intelligible; and

[62] Parkview Building & Loan Ass'n v. Herold, 203 Fed. 876, affirmed 210 Fed. 577.

[63] Haiku Sugar Co. v. Johnstone, 249 Fed. 103; U. S. v. Coulby, 251 Fed. 982, affirmed 258 Fed. 27; First Trust & Savings Bank v. Smietanka, 268 Fed. 230; Scott v. Western Pac. Ry. Co., 246 Fed. 545; see Miller v. Gearin, 258 Fed. 225 as to the 1916 Law; see Wabash Railway Co. v. Edwards, 264 Fed. 610 as to the Stamp Tax Act, (all decided since the Gould case, cited hereafter); see also New York Trust Co. v. Eisner, U. S. Dist. Ct., So. Dist., N. Y., N. Y. Law Journal, March 4, 1920.

[64] U. S. v. Field, decided by U. S. Supreme Court, February 28, 1921; W. T. D. 1921, ¶ 362.

[65] Spreckels Sugar Ref. Co. v. McClain, 192 U. S. 397.

[66] Gould v. Gould, 245 U. S. 151. It is to be noted that in this case the court used almost identically the language of Judge Story in the old Wigglesworth case; also that Mr. Justice McReynolds makes no reference to the Stowell case (cited hereafter). See Crocker v. Malley, 249 U. S. 223.

[67] Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918; Anderson v. Morris & E. R. Co., 216 Fed. 83; Penn. Steel Co. v. N. Y. City Co., 198 Fed. 774, affirmed 231 U. S. 144.

[68] Lynch v. Union Trust Co., 164 Fed. 161.

[69] U. S. v. Distilled Spirits, 27 Fed. Cas. No. 15,960; 10 Blatch. 428.

those whose business it is to construe or expound a law which is of doubtful or double meaning, should not incline to the harshest possible meaning, when it is obvious that those to whom it is to be applied may well have been led to trust in another which is less severe, but equally satisfying in its terms. This is not saying that laws of the kind in question are to be strictly construed in favor of the subject and against the state but, only, that they should be construed with reasonable fairness to the citizen." [70] A third line of cases announces a rule much more favorable to the government. As stated in the early cases, penalties annexed to violations of the general revenue laws do not make them penal in the sense which requires them to be construed strictly.[71] This statement was amplified and further explained in the leading case of U. S. v. Stowell,[72] which was an information on forfeiture of distilling machinery, on the theory that statutes to prevent frauds on the revenue are considered as enacted for the public good and to suppress a public wrong, and therefore, although they impose penalties or forfeitures, are not to be construed, like penal laws generally, strictly in favor of the defendant; but they

[70] The U. S. v. Distilled Spirits case was a penalty case arising under the Internal Revenue Laws and the rule announced in it seems to have been modified by the Stowell case (cited hereafter).

[71] U. S. v. Barrels of Spirits, 2 Abb. (U. S.) 305, 314; U. S. v. Cases of Cloth, Crabbe 356; Taylor v. U. S., 3 How. 197; Cliquot's Champagne, 3 Wall. 114, 145; U. S. v. Hodson, 10 Wall. 395, 406.

[72] U. S. v. Stowell, 133 U. S. 1. It is to be doubted whether in this case or the case of U. S. v. Hodson, 10 Wall. 395, 406, the Supreme Court meant to overrule Judge Story in the Wigglesworth case. In both cases the court refers as authority to the case of Taylor v. U. S., 3 How. 197, 210, which was decided by Judge Story without mentioning his immediately previous opinion in the Wigglesworth case. It seems highly improbable Judge Story meant to overrule himself in the Taylor case but rather that he had a distinction in mind between revenue laws generally and statutes to prevent fraud upon the revenue. At the time of the Wigglesworth decision Judge Story had also decided the case of U. S. v. Breed, 24 Fed. Cas. No. 14,638 in which he said in part: "Revenue and duty acts are not in the sense of the law penal acts; and are not therefore to be construed strictly. Nor are they, on the other hand, acts in furtherance of private rights and liberty, or remedial; and therefore to be construed with extraordinary liberality. They are to be construed according to the true import and meaning of their terms; and when the legislative intention is ascertained, that, and that only, is to be our guide in interpreting them. We are not to strain them to reach cases not within their terms, even if we might conjecture that public policy might have reached those cases; nor, on the other hand, are we to restrain their terms, so as to exclude cases clearly within them, simply because public policy might possibly dictate such an exclusion." See also Rankin v. Hoyt, 4 How. 332; Smythe v. Fiske, 23 Wall, 374, 380. In the last mentioned case the question was the amount of duty on silk ties.

are to be fairly and reasonably construed, so as to carry out the intention of the legislature. This case has been cited and followed constantly[73] notably in a recent case[74] in the Supreme Court construing certain forfeiture provisions of the internal revenue laws, and its authority has never been expressly questioned or restricted. The latest statement of the United States Supreme Court referred to above[75] makes it clear that revenue laws, as to the persons and things to be taxed will be strictly construed in the sense that their provisions will not be extended beyond the clear import of the language used or their operations enlarged so as to embrace matters not specifically pointed out, and that doubt as to such matters will be resolved more strongly against the government and in favor of the citizen. In respect to their penal provisions, however, both those working forfeitures and those imposing penalties or imprisonment, rather than in respect to the question of whom and what the statute taxes, it may still be that revenue laws will be considered as remedial in their character and so liberally construed so as to carry out the purpose of their enactment.[76]

[73] In the following cases involving the construction of revenue laws with particular reference to penal forfeitures and criminal provisions for violations: U. S. v. Two Barrels of Whisky, 96 Fed. 479; U. S. v. 246½. Pounds of Tobacco, 103 Fed. 791; 581 Diamonds v. U. S., 119 Fed. 556, 561; U. S. v. Cole, 134 Fed. 697; U. S. v. Gallant, 177 Fed. 281; U. S. v. Thompson, 189 Fed. 838. In the following cases with particular reference to bonds to protect the government against violations: U. S. v. Nat. Surety Co., 122 Fed. 904, 909; U. S. v. Zemel, 137 Fed. 989; U. S. v. U. S. Fidelity & G. Co., 144 Fed. 866. In the following cases as authority for the liberal construction of miscellaneous laws; Roberts v. Pacific Nav. Co., 104 Fed. 577; U. S. v. St. Louis S. W. Ry., 189 Fed. 954, 962; U. S. v. Ramsey, 197 Fed. 144, 147; U. S. v. Brown, 224 Fed. 135; Johnson v. Southern Pacific Co., 196 U. S. 1. See also Sesnon Co. v. U. S., 182 Fed. 573, writ of certiorari denied 220 U. S. 609. Before the Stowell decision there were cases adopting a strict construction even of statutes to prevent frauds on the revenue. See U. S. v. 84 Boxes of Sugar, 7 Pet. 453 (expressly disapproved in the Stowell case); Sixty Pipes Brandy, 10 Wheat. 424; U. S. v. A Lot of Silk Umbrellas, 12 Fed. 412 (citing U. S. v. 84 Boxes Sugar); U. S. v. Ten Cases Shawls, 28 Fed. Cas. No. 16,448. One case adopting a strict construction of the statute to prevent frauds on the revenue since the Stowell case is U. S. v. 1,150½ Pounds Celluloid, 82 Fed. 634 (citing U. S. v. 84 Boxes of Sugar, supra, and not citing the Stowell case).

[74] U. S. v. Graft Distilling Co., 208 U. S. 198.

[75] See Gould v. Gould, 245 U. S. 151.

[76] This distinction will not reconcile all the cases. For instance, the early cases of Smythe v. Fiske (See Note 72) and Rankin v. Hoyt, (See Note 72), the latter cases of Hunter v. Corning & Co., 86 Fed. 913; Lowe v. Farbwerke-Hoechst Co., 240 Fed. 671; De Ganay v. Lederer, 239 Fed. 568 (affirmed 250 U. S. 376), clearly contemplate the application of the liberal con-

Exemption from Taxation. This paragraph deals only with the construction of the language of a tax law which exempts. The rules of construction applicable to language which lays the tax have already been discussed.[77] The distinction between the rules of construction applicable to language laying the tax and language exempting from tax is important, for, as has been observed, in respect to the former, doubts will be resolved most strongly against the government and in favor of the citizen, while in respect to the latter, as will appear, a most strict construction in favor of the government is called for.[78] The taxing power is of vital importance and is essential to the existence of government; the whole community is interested in maintaining it undiminished.[79] Exemptions from taxation are regarded as in derogation of sovereignty [80] and it is abundantly established that the taxing power should never be presumed to be relinquished unless the intention to do so be declared in clear and unambiguous terms,[81] which will admit of no other construction [82] and which are too plain to be mistaken.[83] The existence of a well founded or rational doubt is equivalent to a denial of a claim to exemption.[84] No claim can be sustained unless within the express letter or the necessary scope of the exempting clause,[85] construed *stictissimi juris;*[86] an exemption will not be inserted in a statute by construction.[87] But this salutary rule requiring a strict construction of exemptions must not be misunderstood. It is not a substitute for all other rules and does not mean that whenever a controversy is or can be raised as to the meaning of a taxing statute, such ambiguity occurs as im-

struction with respect to subjects and objects of taxation. On the other hand, the case of U. S. v. Distilled Sprits (See Note 69), contemplates the application of the rule of liberal construction as announced in the Stowell case in a modified form; that is, neither liberally nor strictly but "with reasonable fairness to the citizen."

77 See paragraph headed "Strict or Liberal Construction."

78 Herold v. Parkview Building & Loan Ass'n, 210 Fed. 577.

79 Providence Bank v. Billings, 4 Pet. 514; Christ Church v. Philadelphia County, 24 How. 300.

80 Yazoo & Miss. Valley R. Co. v. Thomas, 132 U. S. 174.

81 Tennessee v. Whitworth, 117 U. S. 139; Keokuk & W. R. Co. v. Missouri, 152 U. S. 301.

82 Southwestern R. R. Co. v. Wright, 116 U. S. 231.

83 Chicago, etc., R. R. Co. v. Missouri, 120 U. S. 569.

84 Phoenix Fire Ins. Co. v. Tennessee, 161 U. S. 174; Wright v. Georgia R., etc., Co., 216 U. S. 420.

85 Ford v. Delta & Pine Land Co., 164 U. S. 662.

86 Vicksburg S. & P. R. Co. v. Dennis, 116 U. S. 665.

87 Providence Bank v. Billings, 4 Pet. 514; U. S. v. Coulby, 251 Fed. 982.

mediately and inevitably to determine its interpretation. The proper office of the rule is to help solve ambiguities, not to compel an immediate surrender to them—to be an element in decision, and effective, perhaps, when all other tests of meaning have been employed which experience has afforded and which it is the duty of courts to consider.[88] And so courts, in construing the exempting clauses of taxing statutes, are not required to hunt for an escape from an exemption, but will, where the intent to exempt clearly appears, give effect to such intent without evasion.[89]

Rule of Construction Followed by the Treasury Department. As a general rule the construction by the treasury department is such as is most favorable to the enforcement of the revenue laws and no liberal interpretation in favor of the individual is indulged in.[90] In announcing this rule the attorney-general cited the cases of Taylor v. U. S.;[91] Cliquot's Champagne,[92] U. S. v. Hodson,[93] and Smythe v. Fiske,[94] and which, as has been stated, construed both statutes to prevent frauds on the revenue and the provisions of taxing statutes, laying the tax. The attorney-general does not appear to have taken account of the distinction which has been pointed out between these two kinds of provisions, so far as their construction is concerned. As a matter of practice the treasury department cannot, of course, assume the balanced judicial attitude of the courts in interpretation of doubtful points, as its function is to administer the law and its duty, primarily, to collect revenue. However, in some cases the department has gone to great length in making a liberal interpretation favorable to the taxpayer.[95]

[88] Citizens Bank v. Parker, 192 U. S. 73.

[89] Buchanan v. Knoxville & O. R. Co., 71 Fed. 324.

[90] 18 Op. Atty. Gen. 246.

[91] 3 How. 197, 210.

[92] 3 Wall. 114.

[93] 10 Wall. 395.

[94] 23 Wall. 374.

[95] Compare, for instance, the Excess-Profits Tax Law of 1917 (Act of October 3, 1917), with the Regulations No. 41, especially § 210 of that law with Reg. 41, Art. 52.

APPENDIX

REVENUE ACT OF 1918[1]

AN ACT TO PROVIDE REVENUE, AND FOR OTHER PURPOSES

(Act of Feb. 24, 1919, Public No. 254)

TITLE 1—GENERAL DEFINITIONS

Section 1. That when used in this Act—

The term "person" includes partnerships and corporations, as well as individuals;

The term "corporation" includes associations, joint-stock companies, and insurance companies;

The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

The term "United States" when used in a geographical sense includes only the states, the territories of Alaska and Hawaii, and the District of Columbia;

The term "secretary" means the secretary of the treasury;

The term "commissioner" means the commissioner of internal revenue;

The term "collector" means collector of internal revenue;

The term "Revenue Act of 1916" means the Act entitled "An Act to increase the revenue, and for other purposes," approved September 8, 1916;

The term "Revenue Act of 1917" means the Act entitled "An Act to provide revenue to defray war expenses, and for other purposes," approved October 3, 1917;

The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this Act;

The term "government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law;

The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the

1 Only those parts of the Act which apply to the taxes treated in this book are reprinted here.

Navy Nurse Corps, Female, but this shall not be deemed to exclude other units otherwise included within such term;

The term "present war" means the war in which the United States is now engaged against the German government.

For the purposes of this Act the date of the termination of the present war shall be fixed by proclamation of the President.

TITLE II—INCOME TAX

Part I—General Provisions

DEFINITIONS

Sec. 200. That when used in this title—

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under § 212 or § 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1918, shall be the calendar year 1918 or any fiscal year ending during the calendar year 1918;

The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of § 221 or § 237;

The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive;

The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under § 212.

DIVIDENDS

Sec. 201. (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of § 234) means (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.

(b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28,

1913, or, in the case of a personal service corporation, from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

(c) A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed. Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.

(d) If any stock dividend (1) is received by a taxpayer between January 1 and November 1, 1918, both dates inclusive, or (2) is during such period bona fide authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of thirty days after passage of this Act, then such dividend shall, in the manner provided in § 206, be taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits.

(e) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period.

BASIS FOR DETERMINING GAIN OR LOSS

Sec. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value if the inventory is made in accordance with § 203.

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities

exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

INVENTORIES

Sec. 203. That whenever in the opinion of the commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taxen by such taxpayer upon such basis as the commissioner, with the approval of the secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

NET LOSSES

Sec. 204. (a) That as used in this section the term "net loss" refers only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the bona fide sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war; and when so resulting means the excess of the deductions allowed by law (excluding in the case of corporations amounts allowed as a deduction under ¶ (6) of subdivision (a) of § 234) over the sum of the gross income plus any interest received free from taxation both under this title and under Title III.

(b) If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall under regulations prescribed by the commissioner with the approval of the secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and by Title III for such preceding taxable year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of § 252. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall under regulations prescribed by the commissioner with the approval of the secretary be allowed as a deduction in computing the net income for the succeeding taxable year.

(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust under regulations prescribed by the commissioner with the approval of the secretary.

FISCAL YEAR WITH DIFFERENT RATES

Sec. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1917 and ending in 1918, his tax under this title for the first taxable year shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 and under Title I of the Revenue Act of 1917, which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the

entire period: *Provided*, That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (1).

Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917, and by Title I of the Revenue Act of 1917, shall be credited towards the payment of the tax imposed for such fiscal year by this act, and if the amount so paid exceeds the amount of such tax imposed by this act, or, in the case of a personal service corporation, the amount specified in clause (1), the excess shall be credited or refunded in accordance with the provisions of § 252.

(b) If a taxpayer makes a return for a fiscal year beginning in 1918 and ending in 1919, the tax under this title for such fiscal year shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year 1919 which portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a fiscal year of a partnership begins in 1917 and ends in 1918 or begins in 1918 and ends in 1919, then notwithstanding the provisions of subdivision (b) of § 218, (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year: *Provided*, That in the case of a personal service corporation with respect to a fiscal year beginning in 1917 and ending in 1918, the amount specified in clause (1) shall not be subject to normal tax.

PARTS OF INCOME SUBJECT TO RATES FOR DIFFERENT YEARS

Sec. 206. That whenever parts of a taxpayer's income are subject to rates for different calendar years, the part subject to the rates for the most recent calendar year shall be placed in the lower brackets of the rate schedule provided in this title, the part subject to the rates for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to that year, and so on until the entire net income has been accounted for. In determining the income, any deductions, exemptions or credits of a kind not plainly and properly chargeable against the income taxable at rates for a preceding year shall first be applied against the income subject to rates for the most recent calendar year; but any balance thereof shall be applied against the income subject to the rates of the next preceding year or years until fully allowed.

PART II—INDIVIDUALS

NORMAL TAX

Sec. 210. That, in lieu of the taxes imposed by subdivision (a) of § 1 of the Revenue Act of 1916 and by § 1 of the Revenue Act of 1917, there shall

be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax at the following rates:

(a) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in § 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 6 per centum;

(b) For each calendar year thereafter, 8 per centum of the amount of the net income in excess of the credits provided in § 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

SURTAX

Sec. 211. (a) That, in lieu of the taxes imposed by subdivision (b) of § 1 of the Revenue Act of 1916 and by § 2 of the Revenue Act of 1917, but in addition to the normal tax imposed by § 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000;

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, (or any interest therein), where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

NET INCOME DEFINED

Sec. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in § 213, less the deductions allowed by § 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in § 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the commissioner, be computed on the basis of such new accounting period, subject to the provisions of § 226.

GROSS INCOME DEFINED

Sec. 213. That for the purposes of this title (except as otherwise provided in § 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the supreme and inferior courts of the United States, and all other officers and employes, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision

thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of § 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

(4) Interest upon (a) the obligations of a state, territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation; *Provided*, That every person owning any of the obligations, securities or bonds enumerated in clauses (a), (b), (c) and (d) shall, in return required by this title, submit a statement showing the number and amount of such obligations, securities and bonds owned by him and the income received therefrom, in such form and with such information as the commissioner may require. In the case of obligations of the United States issued after September 1, 1917, and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under this title and under Title III;

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any state, territory, or the District of Columbia, or any political subdivision of a state or territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whenever any state, territory, or the District of Columbia, or any political subdivision of a state or territory, prior to September 8, 1916, entered

in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such state, or territory, District of Columbia, or political subdivision; but this provision is not intended to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) So much of the amount received during the present war by a person in the military or naval forces of the United States as salary or compensation in any form from the United States for active services in such forces, as does not exceed $3,500.

(c) In the case of nonresident alien individuals, gross income includes only the gross income from sources within the United States, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED

Sec. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a nonresident alien individual, the proportion of such interest which the amount of his gross income from sources within the United States bears to the amount of his gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under § 222; or (c) by the authority of any state or territory, or any county, school district, municipality, or other taxing subdivision of any state or territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) in the case of a citizen or resident of the United States, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under § 222; or (e) in the case of a nonresident alien individual, by the authority of any foreign country (except income, war-profits and

excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business.

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only as to such transactions within the United States;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arisnig from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise;

(7) Debts ascertained to be worthless and charged off within the taxable year;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time within three years after the termination of the present war, the commissioner may, and at the request of the taxpayer shall, re-examine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of § 252;

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the commissioner

with the approval of the secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and the lessee;

(11) Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to the special fund for vocational rehabilitation authorized by § 7 of the Vocational Rehabilitation Act, to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the commissioner, with the approval of the secretary. In the case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to such vocational rehabilitation fund;

(12) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim in decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the commissioner that such substantial loss has been sustained, then in computing the tax imposed by this title the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the tax imposed by this title for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of § 252.

(b) In the case of a nonresident alien individual the deductions allowed in ¶¶ (1), (4), (7), (8), (9), (10) and (12), and clause (e) of ¶ (3), of subdivision (a) shall be allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the commissioner with the approval of the secretary.

ITEMS NOT DEDUCTIBLE

Sec. 215. That in computing net income no deduction shall in any case be allowed in respect of—

(a) Personal, living, or family expenses;

(b) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(c) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(d) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

CREDITS ALLOWED

Sec. 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends from a corporation which is taxable under this title upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by Act of Congress;

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under § 213;

(c) In the case of a single person, a personal exemption of $1,000, or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,000. A husband and wife living together shall receive but one personal exemption of $2,000 against their aggregate net income; and in case they make separate returns, the personal exemption of $2,000 may be taken by either or divided between them;

(d) $200 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

(e) In the case of a nonresident alien individual who is a citizen or subject of a country which imposes an income tax, the credits allowed in subdivisions (c) and (d) shall be allowed only if such country allows a similar credit to citizens of the United States not residing in such country.

NON-RESIDENT ALIENS—ALLOWANCE OF DEDUCTIONS AND CREDITS

Sec. 217. That a nonresident alien individual shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States, in the manner prescribed by this title, including therein all the information which the commissioner may deem necessary for the calculation of such deductions and credits: *Provided*, That the benefit of the credits allowed in subdivisions (c) and (d) of § 216 may, in the discretion of the commissioner, and except as otherwise provided in subdivision (e) of that section, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such nonresident alien individual shall be liable to distraint for the tax.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS

Sec. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under § 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of § 216 as are received by the partnership.

(b) If a fiscal year of a partnership ends during a calendar year for which the rates of tax differ from those for the preceding calendar year, then (1) the rates for such preceding calendar year shall apply to an amount of each partner's share of such partnership net income equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to the remainder.

(c) In the case of an individual member of a partnership which makes return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess-profits tax imposed upon the partnership under the Revenue Act of 1917 with respect to that part of such fiscal year falling in 1917, shall, for the purpose of determining the tax imposed by this title, be credited against that portion of the net income embraced in his personal return for the taxable year 1918 to which the rates for 1917 apply.

(d) The net income of the partnership shall be computed in the same manner and on the same basis as provided in § 212 except that the deduction provided in ¶ (11) of subdivision (a) of § 214 shall not be allowed.

(e) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: *Provided*, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

ESTATES AND TRUSTS

Sec. 219. (a) That the tax imposed by §§ 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in § 212, except that there shall also be allowed as a deduction (in lieu of the deduction authorized by ¶ (11) of subdivision (a) of § 214) any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for the United States, any state, territory, or any political subdivision thereof, or the District of Columbia, or any corporation organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; and in cases under ¶ (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of each beneficiary's distributive share of such net income, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under ¶ (1), (2), or (3) of subdivision (a) the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under § 216.

(d) In cases under ¶ (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the estate or trust for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the estate or trust is computed, then his distributive share of the net income of the estate or trust for any accounting period of such estate or trust ending within the fiscal or calendar year upon the basis of which such beneficiary's net income is computed. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits in addition to the credits allowed to him under § 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of § 216 as are received by the estate or trust.

PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS

Sec. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by § 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of § 218 in the case of stockholders of a personal service corporation, except that the tax imposed

by Title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

PAYMENT OF TAX AT SOURCE

Sec. 221. (a) That all individuals, corporations and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual (other than income received as dividends from a corporation which is taxable under this title upon its net income) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the commissioner under § 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof: *Provided*, That the commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individually or to an individual citizen or resident of the United States or to a partnership: *Provided*, That the commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1, a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of § 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the commissioner under § 217.

(c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before

March first of each year and shall on or before June fifteenth pay the tax to the official of the United States government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section.

(d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

CREDIT FOR TAXES

Sec. 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States, the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States who is a citizen or subject of a foreign country, the amount of any such taxes paid during the taxable year to such country, upon income derived from sources therein, if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the commissioner who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of § 252. In the case of such a tax accrued but not paid, the commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the commissioner in such penal sum as the commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, and all other information necessary for the computation of such credits.

INDIVIDUAL RETURNS

Sec. 223. That every individual having a net income for the taxable year of $1,000 or over if single or if married and not living with husband or wife, or of $2,000 or over if married and living with husband or wife, shall make under oath a return stating specifically the items of his gross income and the deductions and credits allowed by this title. If a husband and wife living together have an aggregate net income of $2,000 or over, each shall make such a return unless the income of each is included in a single joint return.

If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

PARTNERSHIP RETURNS

Sec. 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

FIDUCIARY RETURNS

Sec. 225. That every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife, or $2,000 or over if married and living with husband or wife, or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a nonresident alien, stating specifically the items of the gross income and the deductions and credits allowed by this title. Under such regulations as the commissioner with the approval of the secretary may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be a sufficient compliance with the above requirement. The fiduciary shall make oath that he has sufficient knowledge of the affairs of such individual, estate or trust to enable him to make the return, and that the same is, to the best of his knowledge and belief, true and correct.

Fiduciaries required to make returns under this act shall be subject to all the provisions of this act which apply to individuals.

RETURNS WHEN ACCOUNTING PERIOD CHANGED

Sec. 226. That if a taxpayer, with the approval of the commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December thirty-first. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar

year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year.

In all of the above cases the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included; and the credits provided in subdivisions (c) and (d) of § 216 shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months.

TIME AND PLACE FOR FILING RETURNS

Sec. 227. (a) That returns shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the fifteenth day of March. The commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

UNDERSTATEMENT IN RETURNS

Sec. 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the commissioner for his decision, under such rules of procedure as may be prescribed by the commissioner with the approval of the secretary.

PART III—CORPORATIONS

TAX ON CORPORATIONS

Sec. 230. (a) That, in lieu of the taxes imposed by § 10 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and by § 4 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(1) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in § 236; and

(2) For each calendar year thereafter, 10 per centum of such excess amount.

(b) For the purposes of the act approved March 21, 1918, entitled "An act to provide for the operation of transportation systems while under federal control, for the just compensation of their owners, and for other purposes," five-sixths of the tax imposed by ¶ (1) of subdivision (a) and four-fifths of the tax imposed by ¶ (2) of subdivision (a) shall be treated as levied by an act in amendment of Title I of the Revenue Act of 1917.

CONDITIONAL AND OTHER EXEMPTIONS

Sec. 231. That the following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members;

(6) Corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in § 26 of the act approved July 17, 1916, entitled "An act to provide capital for agricultural development, to create standard forms of investment based

upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create government depositaries and financial agents for the United States, and for other purposes;"

(14) Personal service corporations.

NET INCOME DEFINED

Sec. 232. That in the case of a corporation subject to the tax imposed by § 230 the term "net income" means the gross income as defined in § 233 less the deductions allowed by § 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of § 212 or in § 226.

GROSS INCOME DEFINED

Sec. 233. (a) That in the case of a corporation subject to the tax imposed by § 230 the term "gross income" means the gross income as defined in § 213, except that:

(1) In the case of life insurance companies there shall not be included in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year.

(2) Mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(b) In the case of a foreign corporation gross income includes only the gross income from sources within the United States, including the interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by § 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a foreign corporation, the proportion of such interest which the amount of its gross income from sources within the United States bears to the amount of its gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under § 238; or (c) by the authority of any state or territory, or any county, school district, municipality, or other taxing subdivision of any state or

territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) in the case of a domestic corporation, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under § 238; or (e) in the case of a foreign corporation, by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon the property or business: *Provided*, That in the case of obligors specified in subdivision (b) of § 221 no deduction for the payment of the tax imposed by this title or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

(5) Debts ascertained to be worthless and charged off within the taxable year;

(6) Amounts received as dividends from a corporation which is taxable under this title upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by Act of Congress;

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time within three years after the termination of the present war, the commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of § 252;

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made

under rules and regulations to be prescribed by the commissioner with the approval of the secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(10) In the case of insurance companies, in addition to the above: (a) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with state or territorial officers pursuant to law as additions to guarantee or reserve funds); and (b) the sums other than dividends paid within the taxable year on policy and annuity contracts;

(11) In the case of corporations issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the commissioner finds to be required for the protection of the holders of such policies only;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in ¶¶ (1) to (10), inclusive, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (other than mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deduction allowed in ¶¶ (1) to (10), inclusive, (unless otherwise allowed under such paragraphs) the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the commissioner that such substantial loss has been sustained, then in computing the taxes imposed by this title and by Title III the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the taxes imposed by this title and by Title III for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of § 252.

(b) In the case of a foreign corporation the deductions allowed in subdivision (a), except those allowed in ¶ (2) and in clauses (a), (b), and (c) of ¶ (3), shall be allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the commissioner with the approval of the secretary.

ITEMS NOT DEDUCTIBLE

Sec. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in §215.

CREDITS ALLOWED

Sec. 236. That for the purpose only of the tax imposed by § 230 there shall be allowed the following credits:

(a) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under § 233;

(b) The amount of any taxes imposed by Title III for the same taxable year: *Provided,* That in the case of a corporation which makes return for a fiscal year beginning in 1917 and ending in 1918, in computing the tax as provided in subdivision (a) of § 205, the tax computed for the entire period under Title II of the Revenue Act of 1917 shall be credited against the net income computed for the entire period under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 and under Title I of the Revenue Act of 1917, and the tax computed for the entire period under Title III of this Act at the rates prescribed for the calendar year 1918 shall be credited against the net income computed for the entire period under this title; and

(c) In the case of a domestic corporation, $2,000.

PAYMENT OF TAX AT SOURCE

Sec. 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in § 221 a tax equal to 10 per centum thereof, and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided,* That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

CREDIT FOR TAXES

Sec. 238. (a) That in the case of a domestic corporation the total taxes imposed for the taxable year by this title and by Title III shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States.

If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the commissioner who shall redetermine the amount of the taxes due under this title and under Title III for the year or

years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of § 252. In the case of such a tax accrued but not paid, the commissioner as a condition precedent to the allowance of this credit may require the corporation to give bond with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the commissioner may require.

(b) This credit shall be allowed only if the taxpayer furnishes evidence satisfactory to the commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, as the case may be, and all other information necessary for the computation of such credit.

(c) If a domestic corporation makes a return for a fiscal year beginning in 1917 and ending in 1918, only that proportion of this credit shall be allowed which the part of such period within the calendar year 1918 bears to the entire period.

CORPORATION RETURNS

Sec. 239. That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporation of whose business or property they have custody and control.

Returns made under this section shall be subject to the provisions of §§ 226 and 228. When return is made under § 226 the credit provided in subdivision (c) of § 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

CONSOLIDATED RETURNS

Sec. 240. (a) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed by the commissioner with the approval of the secretary, make a consolidated return of net income and invested capital for the purposes of this title and Title III, and the taxes thereunder shall be computed and determined upon the basis of such return: *Provided*, That there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a government

contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income.

In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit of $2,000 (as provided in § 236); in computing the war-profits credit (as provided in § 311) only one specific exemption of $3,000; and in computing the excess-profits credits (as provided in § 312) only one specific exemption of $3,000.

(b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

(c) For the purposes of § 238 a domestic corporation which owns a majority of the voting stock of a foreign corporation shall be deemed to have paid the same proportion of any income, war-profits and excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States, which the amount of any dividends (not deductible under § 234) received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid: *Provided*, That in no such case shall the amount of the credit for such taxes exceed the amount of such dividends (not deductible under § 234) received by such domestic corporation during the taxable year.

TIME AND PLACE FOR FILING RETURNS

Sec. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of § 227.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

PART IV—ADMINISTRATIVE PROVISIONS

PAYMENT OF TAXES

Sec. 250. (a) That except as otherwise provided in this section and §§ 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for pay-

ment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as part of such installment interest thereon at the rate of ½ of 1 per centum per month from the time it would have been due if no extension had been granted until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of § 252.

If the amount already paid is less than that which should have been paid, the difference shall, to the extent not covered by any credits then due to the taxpayer under § 252, be paid upon notice and demand by the collector. In such case if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency, plus interest at the rate of 1 per centum per month on the amount of the deficiency of each installment from the time the installment was due.

If the understatement is false or fraudulent with intent to evade the tax, then, in lieu of the penalty provided by § 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the amount of the deficiency.

(c) If the return is made pursuant to § 3176 of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

(d) Except in the case of false or fraudulent returns with intent to evade the tax, the amount of tax due under any return shall be determined and assessed by the commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or was made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due.

(e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part

of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided,* That as to any such amount which is the subject of a bona fide claim for abatement such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of ½ of 1 per centum per month.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be deemed sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be deemed sufficient notice of the amount due.

(f) In any case in which in order to enforce payment of a tax it is necessary for a collector to cause a warrant of distraint to be served, there shall also be added as part of the tax the sum of $5.

(g) If the commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceeding be brought without delay, the commissioner shall declare the taxable period for such taxpayer terminated at the end of the calendar month then last past and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the commissioner with the approval of the secretary, security approved by the commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes.

RECEIPTS FOR TAXES

Sec. 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by

him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

REFUNDS

Sec. 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the government, and for other purposes," the Revenue Act of 1916, as amended, or the Revenue Act of 1917, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of § 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided*, That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer.

PENALTIES

Sec. 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation. or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

RETURNS OF PAYMENTS OF DIVIDENDS

Sec. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the commissioner, render a correct return duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.

RETURNS OF BROKERS

Sec. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the commissioner, render a correct re-

turn duly verified under oath, under such rules and regulations as the commissioner, with the approval of the secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the commissioner may require, as to each of such customers, as will enable the commissioner to determine whether all income tax due on profits or gains of such cutomers has been paid.

INFORMATION AT SOURCE

Sec. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in §§ 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interests or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1918 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

RETURNS TO BE PUBLIC RECORDS

Sec. 257. That returns upon which the tax has been determined by the commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the secretary and approved by the President: *Provided*, That the proper officers of any state imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the secretary may prescribe: *Provided further*, That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any cor-

poration, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

PUBLICATION OF STATISTICS

Sec. 258. That the commissioner, with the approval of the secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

COLLECTION OF FOREIGN ITEMS

Sec. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the commissioner and shall be subject to such regulations enabling the government to obtain the information required under this title as the commissioner, with the approval of the secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

CITIZENS OF UNITED STATES POSSESSIONS

Sec. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

PORTO RICO AND PHILIPPINE ISLANDS

Sec. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid in accordance with the provisions of the Revenue Act of 1916 as amended.

Returns shall be made and taxes shall be paid under Title I of such Act in Porto Rico or the Philippine Islands, as the case may be, by (1) every individual who is a citizen or resident of Porto Rico or the Philippine Islands or derives income from sources therein, and (2) every corporation created or organized in Porto Rico or the Philippine Islands or deriving income from sources therein. An individual who is neither a citizen nor a resident of Porto Rico or the Philippine Islands but derives income from sources therein, shall be taxed in Porto Rico or the Philippine Islands as a nonresident alien individual, and a corporation created or organized outside Porto Rico or

the Philippine Islands and deriving income from sources therein shall be taxed in Porto Rico or the Philippine Islands as a foreign corporation. For the purposes of § 216 and of ¶ (6) of subdivision (a) of § 234 a tax imposed in Porto Rico or the Philippine Islands upon the net income of a corporation shall not be deemed to be a tax under this title.

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

TITLE III—WAR-PROFITS AND EXCESS-PROFITS TAX

Part I—General Definitions

Sec. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in §§ 200 and 201. The first taxable year for the purposes of this title shall be the same as the first taxable year for the purposes of the income tax under Title II.

Part II—Imposition of Tax

Sec. 301. (a) That in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by this act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

FIRST BRACKET

Thirty per centum of the amount of the net income in excess of the excess-profits credit (determined under § 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

Sixty-five per centum of the amount of the net income in excess of 20 per centum of the invested capital;

THIRD BRACKET

The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under § 311) exceeds the amount of the tax computed under the first and second brackets.

(b) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following:

FIRST BRACKET

Twenty per centum of the amount of the net income in excess of the excess-profits credit (determined under § 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

Forty per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(c) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation which derives in such a year a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and Novem-

ber 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) as the part of the net income attributable to such government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit applicable to the taxable year shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (b) as the part of the net income not attributable to such government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the commissioner with the approval of the secretary.

(d) In any case where the full amount of the excess profit credit is not allowed under the first bracket of subdivision (a) or (b), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket.

(e) For the purposes of the act approved March 21, 1918, entitled "An act to provide for the operation of transportation systems while under federal control, for the just compensation of their owners, and for other purposes," the tax imposed by this title shall be treated as levied by an act in amendment of Title II of the Revenue Act of 1917.

Sec. 302. That the tax imposed by subdivision (a) of § 301 shall in no case be more than 30 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 80 per centum of the amount of the net income in excess of $20,000; the tax imposed by subdivision (b) of § 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; and the above limitations shall apply to the taxes computed under subdivisions (a) and (b) of § 301, respectively, when used in subdivision (c) of that section. Nothing in this section shall be construed in such manner as to increase the tax imposed by § 301.

Sec. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the commissioner with the approval of the secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in §§ 311 and 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *Provided*, That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined

upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in § 302.

Sec. 304. (a) That the corporations enumerated in § 231 shall, to the extent that they are exempt from income tax under Title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

(c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title, and the tax on the remaining portion of the net income shall be the proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

Sec. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

Part III—Credits

Sec. 310. That as used in this title the term "prewar period" means the calendar years 1911, 1912, and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence.

Sec. 311. (a) That the war-profits credit shall consist of the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the average net income of the corporation for the prewar period, plus or minus, as the case may be, 10 per centum of the difference between the average invested capital for the prewar period and the invested capital for the taxable year. If the tax is computed for a period of less than twelve months such amount shall be reduced to the same proportion thereof as the number of months in the period is of twelve months.

(b) If the corporation had no net income for the prewar period, or if the amount computed under ¶ (2) of subdivision (a) is less than 10 per centum of its invested capital for the taxable year, then the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to 10 per centum of the invested capital for the taxable year.

(c) If the corporation was not in existence during the whole of at least one calendar year during the prewar period, then, except as provided in subdivision (d), the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer; but such amount shall in no case be less than 10 per centum of the invested capital of the taxpayer for the taxable year. Such average percentage shall be determined by the commissioner on the basis of data contained in returns made under Title II of the Revenue Act of 1917, and the

average known as the median shall be used. If such average percentage has not been determined and published at least 30 days prior to the time when the return of the taxpayer is due, then for purposes of such return 10 per centum shall be used in lieu thereof; but such average percentage when determined shall be used for the purposes of § 250 in determining the correct amount of the tax.

(d) The war-profits credit shall be determined in the manner provided in subdivision (b) instead of in the manner provided in subdivision (c), in the case of any corporation which was not in existence during the whole of at least one calendar year during the prewar period, if (1) a majority of its stock at any time during the taxable year is owned or controlled, directly or indirectly, by a corporation which was in existence during the whole of at least one calendar year during the prewar period, or if (2) 50 per centum or more of its gross income (as computed under § 233 for income tax purposes) consists of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

(e) A foreign corporation shall not be entitled to a specific exemption of $3,000.

Sec. 312. That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year.

A foreign corporation shall not be entitled to the specific exemption of $3,000.

Part IV—Net Income

Sec. 320. (a) That for the purpose of this title the net income of a corporation shall be ascertained and returned—

(1) For the calendar years 1911 and 1912 upon the same basis and in the same manner as provided in § 38 of the act entitled "An act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, except that taxes imposed by such section and paid by the corporation within the year shall be included;

(2) For the calendar year 1913 upon the same basis and in the same manner as provided in § II of the act entitled "An act to reduce tariff duties and to provide revenue for the government, and for other purposes," approved October 3, 1913, except that taxes imposed by § 38 of such act of August 5, 1909, and paid by the corporation within the year shall be included, and except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the tax imposed by § II of such act of October 3, 1913, shall be deducted; and

(3) For the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this act.

(b) The average net income for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no net income for one or more of such years.

Part V—Invested Capital

Sec. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, secret proc-

esses and formulæ, good will, trade-marks, trade-brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under ¶ (2) of subdivision (a) of § 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of § 326, § 330, and § 331.

(b) For the purposes of this title, the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

Sec. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided*, That the commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in § 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided*, That in no case shall the total amount included under ¶¶ (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of ¶ (2) of subdivision (a) of § 311) be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

Sec. 327. That in the following cases the tax shall be determined as provided in § 328:

(a) Where the commissioner is unable to determine the invested capital as provided in § 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in § 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under § 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Sec. 328. (a) In the cases specified in § 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business,

bears to their average net income (in excess of the specific exemption of \$3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of \$3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under § 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the commissioner in accordance with regulations prescribed by him with the approval of the secretary.

In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 per centum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 per centum or more of the net income, the installments shall in the first instance be computed upon the basis of a tax equal to 50 per centum of the net income. In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 per centum of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of one-half of 1 per centum per month on such excess from the time the installment was due.

(c) The commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in § 257.

Part VI—Reorganization

Sec. 330. That in the case of the reorganization, consolidation, or change of ownership after January 1, 1911, of a trade or business now carried on by a corporation, the corporation shall for the purposes of this title be deemed to have been in existence prior to that date, and the net income and invested capital of such predecessor trade or business for all or any part of the prewar period prior to the organization of the corporation now carrying on such trade or business shall be deemed to have been the net income and invested capital of such corporation.

If such predecessor trade or business was carried on by a partnership or individual the net income for the prewar period shall, under regulations prescribed by the commissioner with the approval of the secretary, be ascertained and returned as nearly as may be upon the same basis and in the same manner as provided for corporations in Title II, including a reasonable deduction for salary or compensation to each partner or the individual for personal services actually rendered.

In the case of the organization as a corporation before July 1, 1919, of any trade or business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1918, and the undistributed profits or earnings of such trade or business shall not be subject to the surtax imposed in § 211, but amounts distributed on or after January 1, 1918, from the earnings of such trade or business shall be taxed to the recipients as dividends, and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided*, That this paragraph shall not apply to any trade or business the net income of which for the taxable year 1918 was less than 20 per centum of its invested capital for such year: *Provided further*, That any taxpayer who takes advantage of this paragraph shall pay the tax imposed by § 1000 of this act and by the first subdivision of § 407 of the Revenue Act of 1916, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value.

If any asset of the trade or business in existence both during the taxable year and any prewar year is included in the invested capital for the taxable year but is not included in the invested capital for such prewar year, or is valued on a different basis in computing the invested capital for the taxable year and such prewar year, respectively, then under rules and regulations to be prescribed by the commissioner with the approval of the secretary such readjustments shall be made as are necessary to place the computation of the invested capital for such prewar year on the basis employed in determining the invested capital for the taxable year.

Sec. 331. In the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *Provided*, That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

PART VII—MISCELLANEOUS

Sec. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1917 and ending in 1918, the tax for the first taxable year under this title shall be the sum of: (1) The same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same

proportion of a tax for the entire period computed under this title at the rates specified in subdivision (a) of § 301 which the portion of such period falling within the calendar year 1918 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1917 shall be credited toward the payment of the tax imposed for such fiscal year by this title, and if the amount so paid exceeds the amount of the tax imposed by this title, the excess shall be credited or refunded to the corporation in accordance with the provisions of § 252.

(b) If a corporation makes return for a fiscal year beginning in 1918 and ending in 1919, the tax for such fiscal year under this title shall be the sum of: (1) The same proportion of a tax for the entire period computed under subdivision (a) of § 301 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under subdivisions (b) or (c) of § 301 which the portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a partnership or a personal service corporation makes return for a fiscal year beginning in 1917 and ending in 1918, it shall pay the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period.

Any tax paid by a partnership or personal service corporation for any period beginning on or after January 1, 1918, shall be immediately refunded to the partnership or corporation as a tax erroneously or illegally collected.

Sec. 336. That every corporation, not exempt under § 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Sec. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

TITLE X—SPECIAL TAXES

[Capital Stock Tax]

Sec. 1000. (a) That on and after July 1, 1918, in lieu of the tax imposed by the first subdivision of section 407 of the Revenue Act of 1916—

(1) Every domestic corporation shall pay annually a special excise tax with respect to carrying on or doing business, equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included;

(2) Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to

$1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June thirtieth.

(b) In computing the tax in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included.

(c) The taxes imposed by this section shall not apply in any year to any corporation which was not engaged in business (or in the case of a foreign corporation not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231. The taxes imposed by this section shall apply to mutual insurance companies, and in the case of every such domestic company the tax shall be equivalent to $1 for each $1,000 of the excess over $5,000 of the sum of its surplus or contingent reserves maintained for the general use of the business and any reserves the net additions to which are included in net income under the provisions of Title II, as of the close of the preceding accounting period used by such company for purposes of making its income tax return: *Provided*, That in the case of a foreign mutual insurance company the tax shall be equivalent to $1 for each $1,000 of the same proportion of the sum of such surplus and reserves, which the reserve fund upon business transacted within the United States is of the total reserve upon all business transacted, as of the close of the preceding accounting period used by such company for purposes of making its income tax return.

(d) Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

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TITLE XI—STAMP TAXES

Sec. 1100. That on and after April 1, 1919, there shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in Schedule A of this title, or for or in respect of the vellum, parchment, or paper upon which such instruments, matters, or things, or any of them, are written or printed, by any person who makes, signs, issues, sells, removes, consigns, or ships the same, or for whose use or benefit the same are made, signed, issued, sold, removed, consigned, or shipped, the several taxes specified in such schedule. The taxes imposed by this section shall, in the case of any article upon which a corresponding stamp tax is now imposed by law, be in lieu of such tax.

Sec. 1101. That there shall not be taxed under this title any bond, note, or other instrument, issued by the United States, or by any foreign Government, or by any State, Territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power; or any bond of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States; or stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, or by mutual ditch or irrigating companies.

Sec. 1102. That whoever—

(a) Makes, signs, issues, or accepts, or causes to be made, signed, issued, or accepted, any instrument, document, or paper of any kind or description whatsoever without the full amount of tax thereon being duly paid:

(b) Consigns or ships, or causes to be consigned or shipped, by parcel post any parcel, package, or article without the full amount of tax being duly paid;

(c) Manufactures or imports and sells, or offers for sale, or causes to be manufactured or imported and sold, or offered for sale, any playing cards, package, or other article without the full amount of tax being duly paid;

(d) Makes use of any adhesive stamp to denote any tax imposed by this title without canceling or obliterating such stamp as prescribed in section 1104;

Is guilty of a misdemeanor and upon conviction thereof shall pay a fine of not more than $100 for each offense.

Sec. 1103. That whoever—

(a) Fraudulently cuts, tears, or removes from any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, any adhesive stamp or the impression of any stamp, die, plate, or other article provided, made, or used in pursuance of this title;

(b) Fraudulently uses, joins, fixes, or places to, with, or upon any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, (1) any adhesive stamp, or the impression of any stamp, die, plate, or other article, which has been cut, torn, or removed from any other vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title; or (2) any adhesive stamp or the impression of any stamp, die, plate, or other article of insufficient value; or (3) any forged or counterfeit stamp, or the impression of any forged or counterfeit stamp, die, plate, or other article;

(c) Willfully removes, or alters the cancellation, or defacing marks of, or otherwise prepares, any adhesive stamp, with intent to use, or cause the same to be used, after it has been already used, or knowingly or willfully buys, sells, offers for sale, or gives away, any such washed or restored stamp to any person for use, or knowingly uses the same;

(d) Knowingly and without lawful excuse (the burden of proof of such excuse being on the accused) has in possession any washed, restored, or altered stamp, which has been removed from any vellum, parchment, paper, instrument, writing, package, or article;

Is guilty of a misdemeanor, and upon conviction shall be punished by a fine of not more than $1,000, or by imprisonment for not more than five years or both, and any such reused, canceled, or counterfeit stamp and the vellum, parchment, document, paper, package, or article upon which it is placed or impressed shall be forfeited to the United States.

Sec. 1104. That whenever an adhesive stamp is used for denoting any tax imposed by this title, except as hereinafter provided, the person using or affixing the same shall write or stamp or cause to be written or stamped thereupon the initials of his or its name and the date upon which the same is attached or used, so that the same may not again be used: *Provided*, That the Commissioner may prescribe such other method for the cancellation of such stamps as he may deem expedient.

Sec. 1105. (a) That the Commissioner shall cause to be prepared and distributed for the payment of the taxes prescribed in this title suitable stamps denoting the tax on the document, articles, or thing to which the same may be affixed, and shall prescribe such method for the affixing of said stamps in

substitution for or in addition to the method provided in this title, as he may deem expedient.

(b) The Commissioner, with the approval of the Secretary, is authorized to procure any of the stamps provided for in this title by contract whenever such stamps can not be speedily prepared by the Bureau of Engraving and Printing; but this authority shall expire on January 1, 1920, except as to imprinted stamps furnished under contract, authorized by the Commissioner.

(c) All internal-revenue laws relating to the assessment and collection of taxes are hereby extended to and made a part of this title, so far as applicable, for the purpose of collecting stamp taxes omitted through mistake or fraud from any instrument, document, paper, writing, parcel, package, or article named herein.

Sec. 1106. That the Commissioner shall furnish to the Postmaster-General without prepayment a suitable quantity of adhesive stamps to be distributed to and kept on sale by the various postmasters in the United States. The Postmaster-General may require each such postmaster to give additional or increased bond as postmaster for the value of the stamps so furnished, and each such postmaster shall deposit the receipts from the sale of such stamps to the credit of and render accounts to the Postmaster-General at such times and in such form as he may by regulations prescribe. The Postmaster-General shall at least once monthly transfer all collections from this source to the Treasury as internal-revenue collections.

Sec. 1107. That the collectors of the several districts shall furnish without prepayment to any assistant treasurer or designated depositary of the United States located in their respective collection districts a suitable quantity of adhesive stamps for sale. In such cases the collector may require a bond, with sufficient sureties, to an amount equal to the value of the adhesive stamps so furnished, conditioned for the faithful return, whenever so required, of all quantities or amounts undisposed of, and for the payment monthly of all quantities or amounts sold or not remaining on hand. The Secretary may from time to time make such regulations as he may find necessary to insure the safekeeping or prevent the illegal use of all such adhesive stamps.

Schedule A—Stamp Taxes

1. Bonds of indebtedness: On all bonds, debentures, or certificates of indebtedness issued by any person, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 of face value or fraction thereof, 5 cents: *Provided*, That every renewal of the foregoing shall be taxed as a new issue: *Provided further*, That when a bond conditioned for the repayment or payment of money is given in a penal sum greater than the debt secured, the tax shall be based upon the amount secured.

2. Bonds, indemnity and surety: On all bonds executed for indemnifying any person who shall have become bound or engaged as surety, and on all bonds executed for the due execution or performance of any contract, obligation, or requirement, or the duties of any office or position, and to account for money received by virtue thereof, and on all policies of guaranty and fidelity insurance, including policies guaranteeing titles to real estate and mortgage guarantee policies, and on all other bonds of any description, made, issued, or executed, not otherwise provided for in this schedule, except such as may be required in legal proceedings, 50 cents: *Provided*, That where a premium is charged for the issuance, execution, renewal or con-

tinuance of such bond the tax shall be 1 cent on each dollar or fractional part thereof the premium charged: *Provided further*, That policies of reinsurance shall be exempt from the tax imposed by this subdivision.

3. Capital stock, issued: On each original issue, whether on organization or reorganization, of certificates of stock, or of profits, or of interest in property or accumulations, by any corporation, on each $100 of face value or fraction thereof, 5 cents: *Provided*, That where a certificate is issued without face value, the tax shall be 5 cents per share, unless the actual value is in excess of $100 per share, in which case the tax shall be 5 cents on each $100 of actual value or fraction thereof.

The stamps representing the tax imposed by this subdivision shall be attached to the stock books and not to the certificates issued.

4. Capital stock, sales or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates, whether made upon or shown by the books of the corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock, interest, or rights, or not, on each $100 of face value or fraction thereof, 2 cents, and where such shares are without par or face value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share, unless the actual value thereof is in excess of $100 per share, in which case the tax shall be 2 cents on each $100 of actual value or fraction thereof: *Provided*, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited: *Provided further*, That the tax shall not be imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts: *Provided further*, That in case of sale where the evidence of transfer is shown only by the books of the corporation the stamp shall be placed upon such books; and where the change of ownership is by transfer of the certificate the stamp shall be placed upon the certificate; and in cases of an agreement to sell or where the transfer is by delivery of the certificate assigned in blank there shall be made and delivered by the seller to the buyer a bill or memorandum of such sale, to which the stamp shall be affixed; and every bill or memorandum of sale or agreement to sell before mentioned shall show the date thereof, the name of the seller, the amount of the sale and the matter or thing to which it refers. Any person liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person, who makes any such sale, or who in pursuance of any such sale delivers any certificate or evidence of the sale of any stock, interest or right, or bill or memorandum thereof, as herein required, without having the proper stamps affixed thereto with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000, or be imprisoned not more than six months, or both.

5. Produce, sales of, on exchange: Upon each sale, agreement of sale, or agreement to sell (not including so-called transferred or scratch sales),

any products or merchandise at, or under the rules or usages of, any exchange, or board of trade, or other similar place, for future delivery, for each $100 in value of the merchandise covered by said sale or agreement of sale or agreement to sell, 2 cents, and for each additional $100 or fractional part thereof in excess of $100, 2 cents: *Provided*, That on every sale or agreement of sale or agreement to sell as aforesaid there shall be made and delivered by the seller to the buyer a bill, memorandum, agreement, or other evidence of such sale, agreement of sale, or agreement to sell, to which there shall be affixed a lawful stamp or stamps in value equal to the amount of the tax on such sale: *Provided further*, That sellers of commodities described herein, having paid the tax provided by this subdivision, may transfer such contracts to a clearing-house corporation or association, and such transfer shall not be deemed to be a sale, or agreement of sale, or an agreement to sell within the provisions of this Act, provided that such transfer shall not vest any beneficial interest in such clearing-house association but shall be made for the sole purpose of enabling such clearing-house association to adjust and balance the accounts of the members of such clearing-house association on their several contracts. Every such bill, memorandum, or other evidence of sale or agreement to sell shall show the date thereof, the name of the seller, the amount of the sale, and the matter or thing to which it refers; and any person liable to pay the tax as herein provided or anyone who acts in the matter as agent or broker for such person, who makes any such sale or agreement of sale, or agreement to sell, or who, in pursuance of any such sale, agreement of sale, or agreement to sell, delivers any such products or merchandise without a bill, memorandum, or other evidence thereof as herein required, or who delivers such bill, memorandum, or other evidence of sale, or agreement to sell, without having the proper stamps affixed thereto, with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000 or be imprisoned not more than six months, or both.

No bill, memorandum, agreement, or other evidence of such sale, or agreement of sale, or agreement to sell, in case of cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered shall be subject to this tax.

6. Drafts or checks (payable otherwise than at sight or on demand) upon their acceptance or delivery within the United States whichever is prior, promissory notes, except bank notes issued for circulation, and for each renewal of the same, for a sum not exceeding $100, 2 cents; and for each additional $100, or fractional part thereof, 2 cents.

This subdivision shall not apply to a promissory note secured by the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is secured by the pledge of such bonds or obligations: *Provided*, That in either case the par value of such bonds or obligations shall be not less than the amount of such note.

7. Conveyances: Deed, instrument, or writing, whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons, by his, her, or their direction, when the consideration or value of the interest or property conveyed, exclusive of the value of any lien or encumbrance remaining thereon at the time of sale, exceeds

$100 and does not exceed $500, 50 cents; and for each additional $500 or fractional part thereof, 50 cents. This subdivision shall not apply to any instrument or writing given to secure a debt.

8. Entry of any goods, wares, or merchandise at any customhouse, either for consumption or warehousing, not exceeding $100 in value, 25 cents; exceeding $100 and not exceeding $500 in value, 50 cents; exceeding $500 in value, $1.

9. Entry for the withdrawal of any goods or merchandise from customs bonded warehouse, 50 cents.

10. Passage ticket, one way or round trip, for each passenger, sold or issued in the United States for passage by any vessel to a port or place not in the United States, Canada, or Mexico, if costing not exceeding $30, $1; costing more than $30 and not exceeding $60, $3; costing more than $60, $5. This subdivision shall not apply to passage tickets costing $10 or less.

11. Proxy for voting at any election for officers, or meeting for the transaction of business, of any corporation, except religious, educational, charitable, fraternal, or literary societies, or public cemeteries, 10 cents.

12. Power of attorney granting authority to do or perform some act for or in behalf of the grantor, which authority is not otherwise vested in the grantee, 25 cents. This subdivision shall not apply to any papers necessary to be used for the collection of claims from the United States or from any state for pensions, back pay, bounty, or for property lost in the military or naval service, or to powers of attorney required in bankruptcy cases.

13. Playing cards: Upon every pack of playing cards containing not more than fifty-four cards, manufactured or imported, and sold, or removed for consumption or sale, a tax of 8 cents per pack.

14. Parcel-post packages: Upon every parcel or package transported from one point in the United States to another by parcel post on which the postage amounts to 25 cents or more, a tax of 1 cent for each 25 cents or fractional part thereof charged for such transportation, to be paid by the consignor.

No such parcel or package shall be transported until a stamp or stamps representing the tax due shall have been affixed thereto.

15. On each policy of insurance, or certificate, binder, covering note, memorandum, cablegram, letter, or other instrument by whatever name called whereby insurance is made or renewed upon property within the United States (including rents and profits) against peril by sea or on inland waters or in transit on land (including transshipments and storage at termini or way points) or by fire, lightning, toronado, windstorm, bombardment, invasion, insurrection or riot, issued to or for or in the name of a domestic corporation or partnership or an individual resident of the United States by any foreign corporation or partnership or any individual not a resident of the United States, when such policy or other instrument is not signed or countersigned by an officer or agent of the insurer in a State, Territory, or district of the United States within which such insurer is authorized to do business, a tax of 3 cents on each dollar, or fractional part thereof of the premium charged: *Provided*, That policies of re-insurance shall be exempt from the tax imposed by this subdivision.

Any person to or for whom or in whose name any such policy or other instrument is issued, or any solicitor or broker acting for or on behalf of such person in the procurement of any such policy or other instrument, shall affix the proper stamps to such policy or other instrument, and for fail-

ure to affix such stamps with intent to evade the tax shall, in addition to other penalties provided therefor, pay a fine of double the amount of the tax.

TITLE XII—TAX ON EMPLOYMENT OF CHILD LABOR

Sec. 1200. That every person (other than a bona fide boys' or girls' canning club recognized by the Agricultural Department of a State and of the United States) operating (a) any mine or quarry situated in the United States in which children under the age of sixteen years have been employed or permitted to work during any portion of the taxable year; or (b) any mill, cannery, workshop, factory, or manufacturing establishment situated in the United States in which children under the age of fourteen years have been employed or permitted to work, or children between the ages of fourteen and sixteen have been employed or permitted to work more than eight hours in any day or more than six days in any week, or after the hour of seven o'clock post meridian, or before the hour of six o'clock ante meridian, during any portion of the taxable year, shall pay for each taxable year, in addition to all other taxes imposed by law, an excise tax equivalent to 10 per centum of the entire net profits received or accrued for such year from the sale or disposition of the product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment.

Sec. 1201. That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such products manufactured within the United States the following items:

(a) The cost of raw materials entering into the production;

(b) Running expenses, including rentals, cost of repairs, and maintenance, heat, power, insurance, management, and a reasonable allowance for salaries or other compensations for personal services actually rendered, and for depreciation;

(c) Interest paid within the taxable year on debts or loans contracted to meet the needs of the business, and the proceeds of which have been actually used to meet such needs;

(d) Taxes of all kinds paid during the taxable year with respect to the business or property relating to the production; and

(e) Losses actually sustained within the taxable year in connection with the business of producing such products, including losses from fire, flood, storm, or other casualties, and not compensated for by insurance or otherwise.

Sec. 1202. That if any such person during any taxable year or part thereof, whether under any agreement, arrangement, or understanding or otherwise, sells or disposes of any product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment at less than the fair market price obtainable therefor either (a) in such manner as directly or indirectly to benefit such person or any person directly or indirectly interested in the business of such person; or (b) with intent to cause such benefit; the gross amount received or accrued for such year or part thereof from the sale or disposition of such product shall be taken to be the amount which would have been received or accrued from the sale or disposition of such product if sold at the fair market price.

Sec. 1203. (a) That no person subject to the provisions of this title shall be liable for the tax herein imposed if the only employment or permission to work which but for this section would subject him to the tax, has been of a child as to whom such person has in good faith procured at the time of employing such child or permitting him to work, and has since in good faith relied upon and kept on file a certificate, issued in such form, under such conditions and by such persons as may be prescribed by a board consisting of the Secretary, the Commissioner, and the Secretary of Labor, showing the child to be of such age as not to subject such person to the tax imposed by this title. Any person who knowingly makes a false statement or presents false evidence in or in relation to any such certificate or application therefor shall be punished by a fine of not less than $100, nor more than $1,000, or by imprisonment for not more than three months, or by both such fine and imprisonment, in the discretion of the court.

In any state designated by such board an employment certificate or other similar paper as to the age of the child, issued under the laws of that state, and not inconsistent with the provisions of this title, shall have the same force and effect as a certificate herein provided for.

(b) The tax imposed by this title shall not be imposed in the case of any person who proves to the satisfaction of the Secretary that the only employment or permission to work which but for this section would subject him to the tax, has been of a child employed or permitted to work under a mistake of fact as to the age of such child, and without intention to evade the tax.

Sec. 1204. That on or before the first day of the third month following the close of each taxable year, a true and accurate return under oath shall be made by each person subject to the provisions of this title to the collector for the district in which such person has his principal office or place of business, in such form as the Commissioner, with the approval of the Secretary, shall prescribe, setting forth specifically the gross amount of income received or accrued during such year from the sale or disposition of the product of any mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment, in which children have been employed subjecting him to the tax imposed by this title, and from the total thereof deducting the aggregate items of allowance authorized by this title, and such other particulars as to the gross receipts and items of allowance as the Commissioner, with the approval of the Secretary may require.

Sec. 1205. That all such returns shall be transmitted forthwith by the collector to the Commissioner, who shall, as soon as practicable, assess the tax found due and notify the person making such return of the amount of tax for which such person is liable, and such person shall pay the tax to the collector on or before thirty days from the date of such notice.

Sec. 1206. That for the purposes of this Act the Commissioner, or any other person duly authorized by him, shall have authority to enter and inspect at any time any mine, quarry, mill, cannery, workshop, factory or manufacturing establishment. The Secretary of Labor, or any person duly authorized by him, shall, for the purpose of complying with a request of the Commissioner to make such an inspection, have like authority, and shall make report to the Commissioner of inspections made under such authority in such form as may be prescribed by the Commissioner with the approval of the Secretary of the Treasury.

Any person who refuses or obstructs entry or inspection authorized by this section shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both such fine and imprisonment.

Sec. 1207. That as used in this title the term "taxable year" shall have the same meaning as provided for the purposes of income tax in section 200. The first taxable year for the purposes of this title shall be the period between sixty days after the passage of this Act and December 31, 1919, both inclusive, or such portion of such period as is included within the fiscal year (as defined in section 200) of the taxpayer.

TITLE XIII—GENERAL ADMINISTRATIVE PROVISIONS[1]

Section 1301. (d) (1) There is hereby created a board to be known as the "Advisory Tax Board," hereinafter called the Board, and to be composed of not to exceed six members to be appointed by the Commissioner with the approval of the Secretary. The Board shall cease to exist at the expiration of two years after the passage of this Act, or at such earlier time as the Commissioner with the approval of the Secretary may designate.

Vacancies in the membership of the Board shall be filled in the same manner as an original appointment. Any member shall be subject to removal by the Commissioner with the approval of the Secretary. The Commissioner with the approval of the Secretary shall designate the chairman of the Board. Each member shall receive an annual salary of $9,000, payable monthly, together with actual necessary expenses when absent from the District of Columbia on official business.

(2) The Commissioner may, and on the request of any taxpayer directly interested shall, submit to the Board any question relating to the interpretation or administration of the income, war-profits or excess-profits tax laws, and the Board shall report its findings and recommendations to the Commissioner.

(3) The Board shall have its office in the Bureau of Internal Revenue in the District of Columbia. The expenses and salaries of members of the Board shall be audited, allowed, and paid out of appropriations for collecting internal revenue, in the same manner as expenses and salaries of employees of the Bureau of Internal Revenue are audited, allowed, and paid.

(4) The Board shall have the power to summon witnesses, take testimony, administer oaths, and to require any person to produce books, papers, documents, or other data relating to any matter under investigation by the Board. Any member of the Board may sign subpoenas and members and employees of the Bureau of Internal Revenue designated to assist the Board, when authorized by the Board, may administer oaths, examine witnesses, take testimony and receive evidence.

Sec. 1305. That all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act, and every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns, and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

Whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

[1] Parts of this title are omitted, being general provisions of no direct application to the taxes treated in this book.

The Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Sec. 1307. That in all cases where the method of collecting the tax imposed by this Act is not specifically provided in this Act, the tax shall be collected in such manner as the Commissioner, with the approval of the Secretary, may prescribe. All administrative and penalty provisions of Title XI of this Act, in so far as applicable, shall apply to the collection of any tax which the Commissioner determines or prescribes shall be paid by stamp.

Sec. 1308. (a) That any person required under Titles V, VI, VII, VIII, IX, X, or XII, to pay, or to collect, account for and pay over any tax, or required by law or regulations made under authority thereof to make a return or supply any information for the purposes of the computation, assessment or collection of any such tax, who fails to pay, collect, or truly account for and pay over any such tax, make any such return or supply any such information at the time or times required by law or regulation shall in addition to other penalties provided by law be subject to a penalty of not more than $1,000.

(b) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax, make such return or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

(c) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax shall in addition to other penalties provided by law be liable to a penalty of the amount of the tax evaded, or not paid, collected, or accounted for and paid over, to be assessed and collected in the same manner as taxes are assessed and collected: *Provided, however,* That no penalty shall be assessed under this subdivision for any offense for which a penalty may be assessed under authority of section 3176 of the Revised Statutes, as amended, or of section 605 or 620 of this Act, or for any offense for which a penalty has been recovered under section 3256 of the Revised Statutes.

(d) The term "person" as used in this section includes an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

Sec. 1309. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

The Commissioner with such approval may by regulation provide that any return required by Titles V, VI, VII, VIII, IX, or X to be under oath

may, if the amount of the tax covered thereby is not in excess of $10, be signed or acknowledged before two witnesses instead of under oath.

Sec. 1313. That in the payment of any tax under this Act not payable by stamp a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

Sec. 1314. That collectors may receive, at par with an adjustment for accrued interest, certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the Secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

Sec. 1316. (a) That section 3220 of the Revised Statutes is hereby amended to read as follows:

"Sec. 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

(b) Section 3225 of the Revised Statutes of the United States is hereby amended to read as follows:

"Sec. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation."

(c) That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal-revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921, and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

Sec. 1317. That sections 3164, 3165, 3167, 3172, 3173, and 3176 of the Revised Statutes as amended are hereby amended to read as follows:

"Sec. 3164. It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States

relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

"Sec. 3165. Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

"Sec. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operation, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

"Sec. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.

"Sec. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: *Provided*, That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, article or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects

liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return, which, being distinctly read, consented to, and signed and verified by oath by the person so owning, possessing, or having the care and management as aforesaid, may be received as the list of such person: *Provided further*, That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest post-office, a note or memorandum addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized government officer to examine the books of such person, firm, or corporation, it shall be lawful for the collector to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person or any other person he may deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned: *Provided*, That 'person' as used in this section, shall be construed to include any corporation, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

"Sec. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

Sec. 1318. That if any person is summoned under this Act to appear, to testify, or to produce books, papers or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions.

Sec. 1319. That whoever in connection with the sale or lease, or offer for sale or lease, of any article, or for the purpose of making such sale or lease, makes any statement, written or oral, (1) intended or calculated to lead any person to believe that any part of the price at which such article is sold or leased, or offered for sale or lease, consists of a tax imposed under the authority of the United States, or (2) ascribing a particular part of such price to a tax imposed under the authority of the United States, knowing that such statement is false or that the tax is not so great as the portion of such price ascribed to such tax, shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not more than $1,000 or by imprisonment not exceeding one year, or both.

Sec. 1320. That wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds in lieu of surety or sureties required by law shall have the same force and effect as

individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds deposited hereunder, and such other United States bonds as may be substituted therefor from time to time as such security, may be deposited with the Treasurer, or an Assistant Treasurer of the United States, a Government depositary, Federal Reserve bank, or member bank, which shall issue receipt therefor, describing such bonds so deposited. As soon as security for the performance of such penal bond is no longer necessary, such bonds so deposited, shall be returned to the depositor: *Provided*, That in case a person or persons supplying a contractor with labor or material as provided by the Act of Congress, approved February 24, 1905 (33 Stat., 811), entitled "An Act to amend an Act approved August thirteenth, eighteen hundred and ninety-four, entitled 'An Act for the protection of persons furnishing materials and labor for the construction of public works,'" shall file with the obligee, at any time after a default in the performance of any contract subject to said Acts, the application and affidavit therein provided, the obligee shall not deliver to the obligor the deposited bonds nor any surplus proceeds thereof until the expiration of the time limited by said Acts for the institution of suit by such person or persons, and, in case suit shall be instituted within such time, shall hold said bonds or proceeds subject to the order of the court having jurisdiction thereof: *Provided further*, That nothing herein contained shall affect or impair the priority of the claim of the United States against the bonds deposited or any right or remedy granted by said Acts or by this section to the United States for default upon any obligation of said penal bond: *Provided further*, That all laws inconsistent with this section are hereby so modified as to conform to the provisions hereof: *And provided further*, That nothing contained herein shall affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The Secretary may prescribe rules and regulations necessary and proper for carrying this section into effect.

TITLE XIV—GENERAL PROVISIONS

Sec. 1400. (a) That the following parts of Acts are hereby repealed, subject to the limitations provided in subdivision (b):

(1) The following titles of the Revenue Act of 1916:

Title I (called "Income Tax");

Title II (called "Estate Tax");

Title III (called "Munitions Manufacturers' Tax"), as amended;

Title IV (called "Miscellaneous Taxes").

(2) The following parts of the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917:

Title III (called "Estate Tax");

Section 402 (called "Returns of Dividends");

(3) The following titles of the Revenue Act of 1917:

Title I (called "War Income Tax");

Title II (called "War Excess-Profits Tax");

Title III (called "War Tax on Beverages");

Title IV (called "War Tax on Cigars, Tobacco, and Manufactures Thereof");

Title V (called "War Tax on Facilities Furnished by Public Utilities, and Insurance");

Title VI (called "War Excise Taxes");

Title VII (called "War Tax on Admissions and Dues");

Title VIII (called "War Stamp Taxes");

Title IX (called "War Estate Tax");

Title X (called "Administrative Provisions");

Title XII (called "Income Tax Amendments").

(b) Such parts of Acts shall remain in force for the assessment and collection of all taxes which have accrued thereunder and for the imposition and collection of all penalties or forfeitures which have accrued and may accrue in relation to any such taxes, and except that the unexpended balance of any appropriation heretofore made and now available for the administration of any such part of an Act shall be available for the administration of this Act or the corresponding provision thereof: *Provided*, That except as otherwise provided in this Act, no taxes shall be collected under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917, or Title I or II of the Revenue Act of 1917, in respect to any period after December 31, 1917: *Provided further*, That the assessment and collection of all estate taxes, and the imposition and collection of all penalties or forfeitures, which have accrued under Title II of the Revenue Act of 1916 as amended by the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917, or Title IX of the Revenue Act of 1917, shall be according to the provisions of Title IV of this Act. In the case of any tax imposed by any part of an Act herein repealed, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under this Act takes effect under the provisions of this Act.

Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 shall remain in force for the assessment and collection of the income tax in Porto Rico and the Philippine Islands, except as may be otherwise provided by their respective legislatures.

Sec. 1401. That section 1100 of the Revenue Act of 1917 is hereby repealed, to take effect on July 1, 1919, and thereafter the rate of postage on all mail matter of the first class shall be the same as the rate in force on October 2, 1917: *Provided*, That letters written and mailed by soldiers, sailors, and marines assigned to duty in a foreign country engaged in the present war may be mailed free of postage, subject to such rules and regulations as may be prescribed by the Postmaster-General.

Section 1107 of such Act is hereby repealed, to take effect July 11, 1919.

Sec. 1402. That if any clause, sentence, paragraph, or part of this Act shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair, or invalidate the remainder of this Act, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment has been rendered.

Sec. 1403. That the Revenue Act of 1916 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 903. That this Act may be cited as the 'Revenue Act of 1916.'"

Sec. 1404. That the Revenue Act of 1917 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 1303. That this Act may be cited as the 'Revenue Act of 1917.'"

Sec. 1405. That this Act may be cited as the "Revenue Act of 1918."

Sec. 1408. That every person who on or after April 6, 1917, has entered into any contract, undertaking, or agreement, with the United States, or with any department, bureau, officer, commission, board, or agency under the United States or acting in its behalf, or with any other person having contract relations with the United States, for the performance of any work or the supplying of any materials or property for the use of or for the account of the United States shall, within thirty days after a request of the Commissioner therefor, file with the Commissioner a true and correct copy of every such contract, undertaking, or agreement.

Whoever fails to comply with such request of the Commissioner shall be guilty of a misdemeanor and shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year or both.

The Commissioner shall (when not violative of the technical military or naval secrets of the Government) have access to all information and data relating to any such contract, undertaking, or agreement, in the possession, control or custody of any department, bureau, board, agency, officer, or commission of the United States, and may call upon any such departments, bureau, board, agency, officer or commission for a full statement and description of any allowance for amortization, obsolescence, depreciation or loss, or of any valuation, appraisal, adjustment or final settlement, made in pursuance of any such contract, undertaking, or agreement.

Sec. 1409. That unless otherwise herein specially provided, this Act shall take effect on the day following its passage.

ACT OF JUNE 13, 1898 (30 STAT. 454), AS AMENDED BY ACT OF MARCH 2, 1901 (31 STAT. 940).[1]

Sec. 13. That any person or persons who shall register, issue, sell, or transfer, or who shall cause to be issued, registered, sold, or transferred, any instrument, document, or paper of any kind or description whatsoever mentioned in Schedule A of this Act, without the same being duly stamped, or having thereupon an adhesive stamp for denoting the tax chargeable thereon, and canceled in the manner required by law with intent to evade the provisions of this Act, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall be punished by a fine not exceeding fifty dollars, or by imprisonment not exceeding six months, or both, in the discretion of the court; and such instrument, document, or paper, not being stamped according to law, shall be deemed invalid and of no effect: *Provided*, That hereafter, in all cases where the party has not affixed to any instrument the stamp required by law thereon at the time of issuing, selling, or transferring the said bonds, debentures, or certificates of stock or of indebtedness, or any instrument, document or paper of any kind or description whatsoever mentioned in Schedule A of this Act, and he or they, or any party having an interest therein, shall be subsequently desirous of affixing such stamp to said instrument, or, if said instrument be lost, to a copy thereof, he or they shall appear before the collector of internal revenue of the proper district, who shall, upon the payment of the price of the proper stamp required by law, and of a penalty of ten dollars, and where the whole amount of the tax denoted by the stamp required shall exceed the sum of fifty dollars, on payment also of interest, at the rate of six per

[1] These provisions are referred to in Chapter 45 on the Stamp Tax.

centum, on said tax from the day on which such stamp ought to have been affixed, affix the proper stamp to such bond, debenture, certificate of stock or of indebtedness or copy, or instrument, document, or paper of any kind or description whatsoever mentioned in Schedule A of this Act, and note upon the margin thereof the date of his so doing, and the fact that such penalty has been paid; and the same shall thereupon be deemed and held to be as valid, to all intents and purposes, as if stamped when made or issued: *And provided further,* That where it shall appear to said collector, upon oath or otherwise, to his satisfaction, that any such instrument has not been duly stamped, at the time of making or issuing the same, by reason of accident, mistake, inadvertence, or urgent necessity, and without any willfull design to defraud the United States of the stamp, or to evade or delay the payment thereof, then and in such case, if such instrument, or, if the original be lost, a copy thereof, duly certified by the officer having charge of any records in which such original is required to be recorded or otherwise duly proven to the satisfaction of the collector, shall, within twelve calendar months after the making or issuing thereof, be brought to the said collector of internal revenue to be stamped, and the stamp tax chargeable thereon shall be paid, it shall be lawful for the said collector to remit the penalty aforesaid and to cause such instrument to be duly stamped. And when the original instrument, or a certified, or duly proven copy thereof, as aforesaid, duly stamped so as to entitle the same to be recorded, shall be presented to the clerk, register, recorder, or other officer having charge of the original record it shall be lawful for such officer, upon the payment of the fee legally chargeable for the recording thereof, to make a new record thereof, or to note upon the original record the fact that the error or omission in the stamping of said original instrument has been corrected pursuant to law; and the original instrument or such certified copy, or the record thereof, may be used in all courts and places in the same manner and with like effect as if the instrument had been originally stamped: *And provided further,* That in all cases where the party has not affixed the stamp required by law upon any such instrument issued, registered, sold, or transferred at a time when and at a place where no collection district was established, it shall be lawful for him or them, or any party having an interest therein, to affix the proper stamp thereto, or, if the original be lost, to a copy thereof. But no right acquired in good faith before the stamping of such instrument, or copy thereof, as herein provided, if such record be required by law, shall in any manner be affected by such stamping as aforesaid.

Sec. 14. That hereafter no instrument, paper or document required by law to be stamped, which has been signed or issued without being duly stamped, or with a deficient stamp, nor any copy thereof, shall be recorded or admitted, or used as evidence in any court until a legal stamp or stamps, denoting the amount of tax, shall have been affixed thereto, as prescribed by law: * * *

Sec. 15. That it shall not be lawful to record or register any instrument, paper, or document required by law to be stamped unless a stamp or stamps of the proper amount shall have been affixed and cancelled in the manner prescribed by law; and the record, registry, or transfer of any such instruments upon which the proper stamp or stamps aforesaid shall not have been affixed and cancelled as aforesaid shall not be used in evidence.

REVENUE ACT OF 1921[1]

PUBLIC NO. 98—67TH CONGRESS

AN ACT TO REDUCE AND EQUALIZE TAXATION, TO PROVIDE REVENUE, AND FOR OTHER PURPOSES

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—GENERAL DEFINITIONS

Section 1. That this Act may be cited as the "Revenue Act of 1921."

Sec. 2. That when used in this Act—

(1) The term "person" includes partnerships and corporations, as well as individuals;

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies;

(3) The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

(4) The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

(5) The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia;

(6) The term "Secretary" means the Secretary of the Treasury;

(7) The term "Commissioner" means the Commissioner of Internal Revenue;

(8) The term "collector" means collector of internal revenue;

(9) The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this Act;

(10) The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female, but this shall not be deemed to exclude other units otherwise included within such terms; and

(11) The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this subdivision, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.

[1] Only those parts of the Act which apply to the taxes treated in this book are reprinted here.

TITLE II—INCOME TAX

PART I—GENERAL PROVISIONS

DEFINITIONS

Sec. 200. That when used in this title—

(1) The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1921, shall be the calendar year 1921 or any fiscal year ending during the calendar year 1921;

(2) The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

(3) The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237;

(4) The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212; and

(5) The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

DIVIDENDS

Sec. 201. (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234 and paragraph (4) of subdivision (a) of section 245) means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913, except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922.

(b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such

stock or shares, and (2) the aggregate amount of such distributions received by him thereon.

(c) Any distribution (whether in cash or other property) made by a corporation to its shareholders or members otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee.

(d) A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913.

(e) For the purposes of this Act, a taxable distribution made by a corporation to its shareholders or members shall be included in the gross income of the distributees as of the date when the cash or other property is unqualifiedly made subject to their demands.

(f) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. This subdivision shall not be in effect after December 31, 1921.

BASIS FOR DETERMINING GAIN OR LOSS

Sec. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

(1) In the case of such property, which should be included in the inventory, the basis shall be the last inventory value thereof;

(2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition;

(3) In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition. The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in subdivision (c) or (e) of section 402.

(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

(3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income.

(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

(d) (1) Where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of this section, be treated as taking the place of the property exchanged therefor, except as provided in subdivision (e);

(2) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph (12) of subdivision

(a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted.

(3) Where no deduction is allowed for a loss or a part thereof under the provisions of paragraph (5) of subdivision (a) of section 214 and paragraph (4) of subdivision (a) of section 234, that part of the property acquired with relation to which such loss is disallowed shall for the purposes of this section be treated as taking the place of the property sold or disposed of.

(e) Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess; but when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, the money or the fair market value of such other property received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess.

(f) Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

INVENTORIES

Sec. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

NET LOSSES

Sec. 204. (a) That as used in this section the term "net loss" means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234, as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4) amounts received as dividends and allowed as a

deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost.

(b) If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust, and to insurance companies subject to the tax imposed by section 243 or 246, under regulations prescribed by the Commissioner with the approval of the Secretary.

(d) If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

FISCAL YEARS 1920-1921 AND 1921-1922

Sec. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1920 and ending in 1921, his tax under this title for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1918 at the rates for the calendar year 1920 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1921, which the portion of such period falling within the calendar year 1921 is of the entire period.

Any amount paid before or after the passage of this Act on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1918 shall be credited toward the payment of the tax imposed for such fiscal year by this Act, and if the amount so paid exceeds the amount of such tax imposed by this Act, the excess shall be credited or refunded in accordance with the provisions of section 252.

(b) If a taxpayer makes return for a fiscal year beginning in 1921 and ending in 1922, his tax under this title for the taxable year 1922 shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title (as in force on December 31, 1921) at the rates for the calendar year 1921 which the portion of such period falling within the calendar year 1921 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title (as in force on January 1, 1922) at the rates for the calendar year 1922 which the portion of such period falling within the calendar year 1922 is of the entire period: *Provided,* That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (2).

(c) If a fiscal year of a partnership begins in 1920 and ends in 1921, or begins in 1921 and ends in 1922, then (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each part-

ner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year.

CAPITAL GAIN

Sec. 206. (a) That for the purpose of this title:

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921;

(3) The term "capital deductions" means such deductions as are allowed under this title for the purpose of computing net income and are properly allocable to or chargeable against items of capital gain as defined in this section;

(4) The term "capital net gain" means the excess of the total amount of capital gain over the sum of the capital deductions and capital losses;

(5) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(6) The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per centum of the total net income. The total tax thus determined shall be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under this title.

(c) In the case of a partnership or of an estate or trust, the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership or estate or trust, and shall be taxed to the member or beneficiary or to the estate or trust as provided in sections 218 and 219, but at the rates and in the manner provided in subdivision (b) of this section.

Part II—Individuals

NORMAL TAX

Sec. 210. That, in lieu of the tax imposed by section 210 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided,* That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

SURTAX

Sec. 211. (a) That, in lieu of the tax imposed by section 211 of the Revenue Act of 1918, but in addition to the normal tax imposed by section 210 of this act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual—

(1) For the calendar year 1921, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000;

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000;

(2) For the calendar year 1922 and each calendar year thereafter, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $6,000 and does not exceed $10,000;

2 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

3 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

4 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

5 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

6 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

8 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

9 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

10 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

11 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

12 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

13 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $36,000;

16 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

17 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

18 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

19 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

20 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

21 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

22 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

23 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

24 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

25 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

26 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

27 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

28 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

29 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

30 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

31 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

32 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

33 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

34 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

35 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

36 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

37 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

38 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

39 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

40 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

41 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

42 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

43 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

44 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

45 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

46 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

47 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

48 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

49 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

50 per centum of the amount by which the net income exceeds $200,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed, for the calendar year 1921, 20 per centum, and for each calendar year thereafter 16 per centum, of the selling price of such property or interest.

NET INCOME OF INDIVIDUALS DEFINED

Sec. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(c) If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

GROSS INCOME DEFINED

Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any

business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes;

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended and shall not be construed to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) The income of a nonresident alien or foreign corporation which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States;

(9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war;

(10) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300;

(11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation;

(12) The receipts of shipowners' mutual protection and indemnity associations, not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or member but such corporations shall be subject as other persons to the tax upon their net income from interest, dividends, and rents.

(c) In the case of a nonresident alien individual, gross income means only the gross income from sources within the United States, determined under the provisions of section 217.

DEDUCTIONS ALLOWED INDIVIDUALS

Sec. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit under section 222, (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and (d) taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer. For the purpose of

this paragraph estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only if and to the extent that the profit, if such transaction had resulted in a profit, would be taxable under this title. No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise. Losses allowed under paragraphs (4), (5), and (6) of this subdivision shall be deducted as of the taxable year in which sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Act of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer

shall, re-examine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further*, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(11) Contributions or gifts made within the taxable year to or for the use of: (A)The United States, any state, territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (B) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the women's auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (C) the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. In the case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States, or to such vocational rehabilitation fund. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the secretary;

(12) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner

with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax acts.

(b) In the case of a nonresident alien individual, the deductions allowed in subdivision (a), except those allowed in paragraphs (5), (6), and (11), shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary. In the case of a citizen entitled to the benefits of section 262 the deductions shall be the same and shall be determined in the same manner as in the case of a nonresident alien individual.

ITEMS NOT DEDUCTIBLE

Sec. 215. (a) That in computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(b) Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this Act for the purpose of computing the net income of an estate or trust but not allowed under the laws of such State, Territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.

CREDITS ALLOWED INDIVIDUALS

Sec. 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (2) from

a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217;

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213;

(c) In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500, unless the net income is in excess of $5,000, in which case the personal exemption shall be $2,000. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500, unless the aggregate net income of such husband and wife is in excess of $5,000, in which case the amount of such personal exemption shall be $2,000. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them. In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000;

(d) $400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective;

(e) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the personal exemption shall be only $1,000, and he shall not be entitled to the credit provided in subdivision (d);

(f) The credits allowed by subdivisions (c), (d), and (e) of this section shall be determined by the status of the taxpayer on the last day of the period for which the return of income is made; but in the case of an individual who dies during the taxable year, such credits shall be determined by his status at the time of his death, and in such case full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the period for which such survivor makes return of income.

NET INCOME OF NONRESIDENT ALIEN INDIVIDUALS

Sec. 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:

(1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including (A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or (B) interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable;

(2) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section;

(3) Compensation for labor or personal services performed in the United States;

(4) Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits, and income from the sale of real property located in the United States.

(b) From the items of gross income specified in subdivision (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(c) The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in paragraph (1) of subdivision (a);

(2) Dividends other than those derived from sources within the United States as provided in paragraph (2) of subdivision (a);

(3) Compensation for labor or personal service performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits, and income from the sale of real property located without the United States;

(d) From the items of gross income specified in subdivision (c) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(e) Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or

class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from the country in which sold.

(f) As used in this section the words "sale" or "sold" include "exchange" or "exchanged"; and the word "produced" includes "created," "fabricated," "manufactured," "extracted," "processed," "cured," or "aged."

(g) A nonresident alien individual or citizen entitled to the benefits of section 262 shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States, in the manner prescribed in this title; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits: *Provided*, That the benefit of the credit allowed in subdivision (e) of section 216 may, in the discretion of the Commissioner, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such nonresident alien individual or foreign trader shall be liable to distraint for the tax.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS

Sec. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

(b) The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

(d) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: *Provided*, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

This subdivision shall not be in effect after December 31, 1921. In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, amounts distributed prior to January 1, 1922, to its stockholders out of earnings or profits accumulated after December 31, 1920, shall be taxed to the distributees; and the stockholders of record on December 31, 1921, shall be taxed upon their distributive shares of the difference (if any) between such distributive profits and the portion of the corporation's net income assignable to the calendar year 1921, determined in the manner provided in clause (1) of subdivision (c) of section 205 of this Act.

ESTATES AND TRUSTS

Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained person or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraphs (1), (2), or (3) of subdivision (a) or in any other case within subdivision (a) of this section except paragraph (4) thereof the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir, or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

(e) In the case of an estate or trust the income of which consists both of income of the class described in paragraph (4) of subdivision (a) of this section and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with subdivision (b) and the tax shall be imposed, and shall be paid by the fiduciary in accordance with subdivision (c), except that there shall be allowed as an additional deduction in computing the net income of the estate or trust that part of its income of the class described in paragraph (4) of subdivision (a) which, pursuant to the instrument or order governing the distribution, is distributable during its taxable year to the beneficiaries. In cases under this subdivision there shall be included, as provided in subdivision (d) of this section, in computing the net income of each beneficiary, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable during the taxable year to such beneficiary.

(f) A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the items specified in subdivisions (a) and (b) of section 216.

EVASION OF SURTAXES BY INCORPORATION

Sec. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: *Provided*, That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

PAYMENT OF INDIVIDUAL'S TAX AT SOURCE

Sec. 221. (a) That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual or partnership composed in whole or in part of nonresident aliens (other than income received as dividends of the class allowed as a credit by subdivision (a) of section 216) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof: *Provided*, That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to

pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *Provided*, That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under subdivision (g) of section 217.

(c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March 1 of each year and shall on or before June 15 pay the tax to the official of the United States government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section.

(d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in the cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

CREDIT FOR TAXES IN CASE OF INDIVIDUALS

Sec. 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States, the amount of any such taxes paid during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes

of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(5) The above credits shall not be allowed in the case of a citizen entitled to the benefits of section 262; and in no other case shall the amount of credit taken under this subdivision exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the Collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credits.

(d) If the taxpayer makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or part, any such credit which he finds has already been taken by the taxpayer.

INDIVIDUAL RETURNS

Sec. 223. (a) That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wfe; and

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income.

(b) If a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000 or over—

(1) Each shall make such a return, or

(2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income.

(c) If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

PARTNERSHIP RETURNS

Sec. 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

FIDUCIARY RETURNS

Sec. 225. (a) That every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife;

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income;

(4) Every estate or trust the net income of which for the taxable year is $1,000 or over; and

(5) Every estate or trust of which any beneficiary is a nonresident alien.

(b) Under such regulations as the Commissioner with the approval of the Secretary may prescribe a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be sufficient compliance with the above requirement. Such fiduciary shall make oath (1) that he has sufficient knowledge of the affairs of the individual, estate or trust for which the return is made, to enable him to make the return, and (2) that the return is, to the best of his knowledge and belief, true and correct. Any fiduciary required to make a return under this Act shall be subject to all the provisions of this Act which apply to individuals.

RETURNS FOR A PERIOD OF LESS THAN TWELVE MONTHS

Sec. 226. (a) That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year.

(b) In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included.

(c) In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

TIME AND PLACE FOR FILING INDIVIDUAL, PARTNERSHIP, AND FIDUCIARY RETURNS

Sec. 227. (a) That returns (except in the case of nonresident aliens) shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

UNDERSTATEMENT IN RETURNS

Sec. 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.

INCORPORATION OF INDIVIDUAL OR PARTNERSHIP BUSINESS

Sec. 229. That in the case of the organization as a corporation within four months after the passage of this act of any trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed profits or earnings of such trade or business shall not be subject to the surtaxes imposed in section 211, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided*, That this section shall not apply to any trade or business, the net income

of which for the taxable year 1921 was less than 20 per centum of its invested capital for such year: *Provided further*, That any taxpayer who takes advantage of this section shall pay the tax imposed by section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921.

Part III.—Corporations

TAX ON CORPORATIONS

Sec. 230. That, in lieu of the tax imposed by section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of such excess amount.

CONDITIONAL AND OTHER EXEMPTIONS OF CORPORATIONS

Sec. 231. That the following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and co-operative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone com-

panies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in section 26 of the Act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create government depositaries and financial agents for the United States, and for other purposes";

(14) Personal service corporations. This subdivision shall not be in effect after December 31, 1921.

NET INCOME OF CORPORATIONS DEFINED

Sec. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.

GROSS INCOME OF CORPORATIONS DEFINED

Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 and 217, except that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(b) In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by sections 243 or 246) in the manner provided in section 217.

DEDUCTIONS ALLOWED CORPORATIONS

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made

as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, and (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed. In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed nor shall such tax be included in the gross income of the obligee. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a corporation upon his interest as shareholder or member, which are paid by the corporation without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes. For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. No deduction shall be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, unless such claim is made by a dealer in stock or securities and with respect to a transaction made in the ordinary course of its business. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(5) Debts ascertained to be worthless and charged off within the taxable year (or in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(6) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its tax-

able year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall re-examine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further*, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(10) In case of insurance companies (other than life insurance companies), in addition to the above (unless otherwise allowed): (A) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the

actual deposit of sums with state or territorial officers pursuant to law as additions to guarantee or reserve funds); and (B) the sums other than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, this subdivision shall apply only to mutual insurance companies other than life insurance companies;

(11) In the case of corporations (except those taxed under section 243) issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only. This subdivision shall not be in effect after December 31, 1921;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax Acts.

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

ITEMS NOT DEDUCTIBLE BY CORPORATIONS

Sec. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

CREDITS ALLOWED CORPORATIONS

Sec. 236. That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits:

(a) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 233;

(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and

(c) The amount of any war-profits and excess-profits taxes imposed by Act of Congress for the same taxable year. The credit allowed by this subdivision shall be determined as follows:

(1) In the case of a corporation which makes return for a fiscal year beginning in 1920 and ending in 1921, in computing the income tax as provided in subdivision (a) of section 205, the portion of the war-profits and excess-profits tax computed for the entire period under clause (1) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (a) of section 205, and the portion of the war-profits and excess-profits tax computed for the entire period under clause (2) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (2) of subdivision (a) of section 205.

(2) In the case of a corporation which makes return for a fiscal year beginning in 1921 and ending in 1922, in computing the income tax as provided in subdivision (b) of section 205, the war-profits and excess-profits tax computed under subdivision (b) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (b) of section 205.

PAYMENT OF CORPORATION INCOME TAX AT SOURCE

Sec. 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided*, That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

CREDIT FOR TAXES IN CASE OF CORPORATIONS

Sec. 238. (a) That in the case of a domestic corporation the tax imposed by this title, plus the war-profits and excess-profits taxes, if any, shall be credited with the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any

possession of the United States: *Provided,* That the amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit it taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year. In the case of domestic insurance companies subject to the tax imposed by section 243 or 246, the term "net income," as used in this subdivision means net income as defined in sections 245 and 246, respectively.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner, who shall redetermine the amount of the income, war-profits and excess-profits taxes for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credit.

(d) If a domestic corporation makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or in part, any such credit which he finds has already been taken by the taxpayer.

(e) For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided,* That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what

year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subdivision shall be construed to mean such accounting period.

(f) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation.

CORPORATION RETURNS

Sec. 239. (a) That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

(b) Returns made under this section shall be subject to the provisions of sections 226 and 228. When return is made under section 226 the credit provided in subdivision (b) of section 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

(c) There shall be included in the return or appended thereto a statement of such facts as will enable the Commissioner to determine the portion of the earnings or profits of the corporation (including gains, profits and income not taxed) accumulated during the taxable year for which the return is made, which have been distributed or ordered to be distributed, respectively, to its stockholders or members during such year.

CONSOLIDATED RETURNS OF CORPORATIONS

Sec. 240. (a) That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.

(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in

such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236.

(c) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all of the stock of the other or others, or (2) if substantially all of the stock of two or more corporations is owned or controlled by the same interests.

(d) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: *Provided,* That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

(e) Corporations which are affiliated within the meaning of this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918.

TIME AND PLACE FOR FILING CORPORATE RETURNS

Sec. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227, except that in the case of foreign corporations not having any office or place of business in the United States returns shall be made at the same time as provided in section 227 in the case of a nonresident alien individual.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

TAXES ON INSURANCE COMPANIES

Sec. 242. That when used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

Sec. 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of a foreign life insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

SEC. 244. (a) That in the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

(b) The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with state or territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

SEC. 245. (a) That in the case of a life insurance company the term "net income" means the gross income less—

(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title;

(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

(3) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;

(4) An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract;

(5) Investment expenses paid during the taxable year: *Provided*, That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

(6) Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a company upon his interest as shareholder or member, which are paid by

the company without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes;

(7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence. In the case of property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(8) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(9) In the case of a domestic life insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 243 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(b) No deduction shall be made under paragraphs (6) and (7) of subdivision (a) on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied.

(c) In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.

Sec. 246. (a) That, in lieu of the taxes imposed by sections 230 and 1000, there shall be levied, collected and paid for the calendar year 1922, and for each taxable year thereafter, upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of such a foreign insurance company the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

(b) In the case of an insurance company subject to the tax imposed by this section—

(1) The term "gross income" means the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners;

(2) The term "net income" means the gross income as defined in paragraph (1) of this subdivision less the deductions allowed by section 247;

(3) The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year;

(4) The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year;

(6) The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year;

(7) The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by section 247.

Sec. 247. (a) That in computing the net income of an insurance company subject to the tax imposed by section 246 there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in paragraph (1) of subdivision (a) of section 234;

(2) All interest as provided in paragraph (2) of subdivision (a) of section 234;

(3) Taxes as provided in paragraph (3) of subdivision (a) of section 234;

(4) Losses incurred;

(5) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(6) The amount received as dividends from corporations as provided in paragraph (6) of subdivision (a) of section 234;

(7) The amount of interest earned during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title, and the amount of interest allowed as a credit under subdivision (a) of section 236;

(8) A reasonable allowance, for the exhaustion, wear and tear of property, as provided in paragraph (7) of subdivision (a) of section 234;

(9) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 246 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(b) In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in subdivision (b) of section 234.

(c) Nothing in this section or in section 246 shall be construed to permit the same item to be twice deducted.

Part IV—Administrative Provisions

PAYMENT OF TAXES

Sec. 250. (a) That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as a part of such installment interest thereon at the rate of one-half of 1 per centum per month from the time it would have been due if no extension had been granted, until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

If the amount already paid is less than that which should have been paid, the difference, to the extent not covered by any credits due to the taxpayer under section 252 (hereinafter called "deficiency"), together with interest thereon at the rate of one-half of 1 per centum per month from the time the tax was due (or, if paid on the installment basis, on the

deficiency of each installment from the time the installment was due), shall be paid upon notice and demand by the collector. If any part of the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency in the tax, and interest in such a case shall be collected at the rate of 1 per centum per month on the amount of such deficiency in the tax from the time it was due (or, if paid on the installment basis, on the amount of the deficiency in each installment from the time the installment was due), which penalty and interest shall become due and payable upon notice and demand by the collector. If any part of the deficiency is due to fraud with intent to evade tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns wilfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the total amount of the deficiency in the tax. In such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector.

(c) If the return is made pursuant to section 3176 of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

(d) The amount of income, excess-profits, or war-profits taxes due under any return made under this Act for the taxable year 1921 or succeeding taxable years shall be determined and assessed by the Commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this Act for prior taxable years or under prior income, excess-profits, or war-profits tax Acts, or under section 38 of the Act entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this Act or under prior income, excess-profits, or war-profits tax Acts, or of any taxes due under section 38 of such Act of August 5, 1909, shall be begun, after the expiration of five years after the date when such return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this Act: *Provided*, That in the case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent: *Provided further*, That in the case of a false or fraudulent return with intent to evade tax, or of a failure to file a required return, the amount of tax due may be determined, assessed, and collected, and a suit or proceeding for the collection of such amount may be begun, at any time after it becomes due: *Provided further*, That in cases coming within the scope of paragraph (9) of subdivision (a) of section 214, or of paragraph (8) of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time;

but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision.

If upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this Act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained: *Provided*, That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing.

(e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided*, That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be sufficient notice of the amount due. In the case of each subsequent installment the collector may, within thirty days and not later than ten days before the installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due for payment. Such notice of the collector shall be sufficient notice and sufficient demand under this section.

(f) In the case of any deficiency (except where the deficiency is due to negligence or to fraud with intent to evade tax) where it is shown to the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for such period not in excess of eighteen months from the passage of this Act as the Commissioner may determine. In such case the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted. There shall be added in lieu of other interest provided by law, as a part of such deficiency, interest thereon at the rate of two-thirds of 1 per centum per month from the time such extension is granted; except where such other interest provided by law is in excess of interest at the rate of two-

thirds of 1 per centum per month. If the deficiency or any part thereof is not paid in accordance with the terms of the extension granted, there shall be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per centum of the deficiency and interest on the deficiency at the rate of 1 per centum per month from the time it becomes payable in accordance with the terms of such extension.

(g) If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes. In the case of a citizen of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision. No alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws. If a taxpayer violates or attempts to violate this subdivision there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time the tax became due.

(h) The provisions of subdivisions (e), (f) and (g) of this section shall apply to the assessment and collection of taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918 or this Act.

RECEIPTS FOR TAXES

Sec. 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

REFUNDS

Sec. 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided*, That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer: *Provided further*, That if upon examination of any return of income made pursuant to the Revenue Act of 1917, the Revenue Act of 1918, or this Act, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that an amount of income tax in excess of that properly due was paid in any previous year or years, then, notwithstanding any other provision of law and regardless of the expiration of such five-year period, the amount of such excess shall, without the filing of any claim therefor, be credited or refunded as provided in this section: *And provided further*, That nothing in this section shall be construed to bar from allowance claims for refund filed prior to the passage of the Revenue Act of 1918 under subdivision (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

PENALTIES

Sec. 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

RETURNS OF PAYMENTS OF DIVIDENDS

Sec. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.

RETURNS OF BROKERS

Sec. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

INFORMATION AT SOURCE

Sec. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of

items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1921 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

RETURNS TO BE PUBLIC RECORDS

Sec. 257. That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: *Provided*, That the proper officers of any state imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further*, That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

PUBLICATION OF STATISTICS

Sec. 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

COLLECTION OF FOREIGN ITEMS

Sec. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such

regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

CITIZENS OF POSSESSIONS OF THE UNITED STATES

Sec. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

Nothing in this section shall be construed to alter or amend the provisions of the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes," approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States.

PORTO RICO AND PHILIPPINE ISLANDS

Sec. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid as provided by law prior to the passage of this Act.

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

INCOME FROM SOURCES WITHIN THE POSSESSIONS OF THE UNITED STATES

Sec. 262. (a) That in the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) Notwithstanding the provisions of subdivision (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

EFFECTIVE DATE OF TITLE

Sec. 263. That this title shall take effect as of January 1, 1921.

TITLE III—WAR-PROFITS AND EXCESS-PROFITS TAX FOR 1921

Part I—General Definitions

Sec. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in sections 200 and 201.

Part II—Imposition of Tax

Sec. 301. (a) That in lieu of the tax imposed by Title III of the Revenue Act of 1918, but in addition to the other taxes imposed by this Act, there shall be levied, collected and paid for the calendar year 1921 upon the net income of every corporation (except corporations taxable under subdivision (b) of this section) a tax equal to the sum of the following:

FIRST BRACKET

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(b) For the calendar year 1921 there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) of section 301 of the Revenue Act of 1918, as the part of the net income attributable to such government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit which would be applicable to such calendar year under the Revenue Act of 1918 if it had been continued in force, shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (a) of this section as the part of the net income not attributable to such government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(c) In any case where the full amount of the excess-profits credit is not allowed under the first bracket of subdivision (a), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket.

Sec. 302. That the tax imposed by subdivision (a) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; and the limitations imposed

by section 302 of the Revenue Act of 1918 (upon taxes computed under subdivision (c) of section 301 of that Act) are hereby made applicable to taxes computed under subdivision (b) of section 301 of this Act. Nothing in this section shall be construed in such manner as to increase the tax imposed by section 301 of this Act.

Sec. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in section 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *Provided*, That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

Sec. 304. (a) That the corporations enumerated in section 231 shall, to the extent that they are exempt from income tax under Title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

(c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title or any tax imposed by Title II of the Revenue Act of 1917, and the tax on the remaining portion of the net income shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

Sec. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

PART III—EXCESS-PROFITS CREDIT

Sec. 312. That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year.

A foreign corporation or a corporation entitled to the benefits of section 262 shall not be entitled to the specific exemption of $3,000.

PART IV—NET INCOME

Sec. 320. That for the purpose of this title the net income of a corporation shall be ascertained and returned for the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this Act.

Part V—Invested Capital

Sec. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, secret processes and formulae, good will, trade-marks, trade brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of section 326 and section 331.

(b) For the purposes of this title the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

Sec. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivision (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided*, That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and the net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares

issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided*, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall be the same fractional part of such average invested capital.

Sec. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Sec. 328. (a) That in the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of

the specific exemption of $3,000) for such year. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and the net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

Part VI—Reorganizations

Sec. 331. That in the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *Provided,* That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

Part VII—Miscellaneous

Sec. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1920 and ending in 1921, the war-profits and excess-profits tax for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under the Revenue Act of 1918, which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period. Any amount heretofore or hereafter paid on account

of the tax imposed for such taxable year by the Revenue Act of 1918 shall be credited towards the payment of the tax as above computed, and if the amount so paid exceeds the amount of such tax, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252 of this Act.

(b) If a corporation (other than a personal service corporation) makes a return for a fiscal year beginning in 1921 and ending in 1922, the war-profits and excess-profits tax for the portion of the year falling within the calendar year 1921 shall be an amount equivalent to the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period.

Sec. 336. That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Sec. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

EFFECTIVE DATE OF TITLE

Sec. 338. That this title shall take effect as of January 1, 1921.

TITLE X—SPECIAL TAXES

CAPITAL STOCK TAX

Sec. 1000. (a) That on and after July 1, 1922, in lieu of the tax imposed by section 1000 of the Revenue Act of 1918—

(1) Every domestic corporation shall pay annually a special excise tax with respect to carrying on or doing business, equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included;

(2) Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to $1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June 30.

(b) The taxes imposed by this section shall not apply in any year to any corporation which was not engaged in business (or, in the case of a foreign corporation, not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231, nor to any insurance company subject to the tax imposed by section 243 or 246.

(c) Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

TITLE XI—STAMP TAXES

Sec. 1100. That on and after January 1, 1922, there shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in schedule A of this title, or for or in respect of the vellum, parchment, or paper upon which such instruments, matters, or things, or any of them, are written or printed, by any person who makes, signs, issues, sells, removes, consigns, or ships the same, or for whose use or benefit the same are made, signed, issued, sold, removed, consigned, or shipped, the several taxes specified in such schedule. The taxes imposed by this section shall, in the case of any article upon which a corresponding stamp tax is now imposed by law, be in lieu of such tax.

Sec. 1101. That there shall not be taxed under this title any bond, note, or other instrument, issued by the United States, or by any foreign government, or by any state, territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power; or any bond of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-savings certificate, warrant or check, issued by the United States; or stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, of by mutual ditch or irrigation companies.

Sec. 1102. That whoever—

(a) Makes, signs, issues, or accepts, or causes to be made, signed, issued, or accepted, any instrument, document, or paper of any kind or description whatsoever without the full amount of tax thereon being duly paid;

(b) Manufactures or imports and sells, or offers for sale, or causes to be manufactured or imported and sold, or offered for sale, any playing cards, package, or other article without the full amount of tax being duly paid;

(c) Makes use of any adhesive stamp to denote any tax imposed by this title without canceling or obliterating such stamp as prescribed in section 1104;

Is guilty of a misdemeanor and upon conviction thereof shall pay a fine of not more than $100 for each offense.

Sec. 1103. That whoever—

(a) Fraudulently cuts, tears, or removes from any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, any adhesive stamp or the impression of any stamp, die, plate, or other article provided, made, or used in pursuance of this title;

(b) Fraudulently uses, joins, fixes, or places to, with, or upon any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, (1) any adhesive stamp, or the impression of any stamp, die, plate, or other article, which has been cut, torn, or removed from any other vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title; or (2) any adhesive stamp or the impression of any stamp, die, plate, or other article of insufficient value; or (3) any forged or counterfeited stamp, or the impression of any forged or counterfeited stamp, die, plate, or other article;

(c) Willfully removes, or alters the cancellation, or defacing marks of, or otherwise prepares, any adhesive stamp, with intent to use, or cause the same to be used, after it has been already used, or knowingly or willfully buys, sells, offers for sale, or gives away, any such washed or restored stamp to any person for use, or knowingly uses the same;

(d) Knowingly and without lawful excuse (the burden of proof of such excuse being on the accused) has in possession any washed, restored, or altered stamp, which has been removed from any vellum, parchment, paper, instrument, writing, package, or article;

Is guilty of a misdemeanor, and upon conviction shall be punished by a fine of not more than $1,000, or by imprisonment for not more than five years, or both, and any such reused, canceled, or counterfeited stamp and the vellum, parchment, document, paper, package, or article upon which it is placed or impressed shall be forfeited to the United States.

Sec. 1104. That whenever an adhesive stamp is used for denoting any tax imposed by this title, except as hereinafter provided, the person using or affixing the same shall write or stamp or cause to be written or stamped thereupon the initials of his or its name and the date upon which the same is attached or used, so that the same may not again be used: *Provided* That the Commissioner may prescribe such other method for the cancellation of such stamps as he may deem expedient.

Sec. 1105. (a) That the Commissioner shall cause to be prepared and distributed for the payment of the taxes prescribed in this title suitable stamps denoting the tax on the document, articles, or thing to which the same may be affixed, and shall prescribe such method for the affixing of said stamps in substitution for or in addition to the method provided in this title, as he may deem expedient.

(b) All internal revenue laws relating to the assessment and collection of taxes are hereby extended to and made a part of this title, so far as applicable, for the purpose of collecting stamp taxes omitted through mistake or fraud from any instrument, document, paper, writing, parcel, package, or article named herein.

Sec. 1106. That the Commissioner shall furnish to the Postmaster General without prepayment a suitable quantity of adhesive stamps to be distributed to and kept on sale by the various postmasters in the United States. The Postmaster General may require each such postmaster to give additional or increased bond as postmaster for the value of the stamps so furnished, and each such postmaster shall deposit the receipts from the sale of such stamps to the credit of and render accounts to the Postmaster General at such times and in such form as he may by regulations prescribe. The Postmaster General shall at least once monthly transfer all collections from this source to the treasury as internal-revenue collections.

Sec. 1107. (a) That each collector shall furnish, without prepayment, to any assistant treasurer or designated depositary of the United States, located in the district of such collector, a suitable quantity of adhesive stamps to be kept on sale by such assistant treasurer or designated depositary.

(b) Each collector shall furnish, without prepayment, to any person who is (1) located in the district of such collector, (2) duly appointed and acting as agent of any state for the sale of stock transfer stamps of such

state, and (3) designated by the Commissioner for the purpose, a suitable quantity of such adhesive stamps as are required by subdivisions 2, 3, and 4 of schedule A of this title, to be kept on sale by such person.

(c) In such cases the collector may require a bond, with sufficient sureties, in a sum to be fixed by the Commissioner, conditioned for the faithful return, whenever so required, of all quantities or amounts undisposed of, and for the payment monthly of all quantities or amounts sold or not remaining on hand. The Secretary may from time to time make such regulations as he may find necessary to insure the safe-keeping or prevent the illegal use of all such adhesive stamps.

Schedule A.—Stamp Taxes

1. Bonds of indebtedness: On all bonds, debentures, or certificates of indebtedness issued by any person, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 or face value or fraction thereof, 5 cents: *Provided*, That every renewal of the foregoing shall be taxed as a new issue: *Provided further*, That when a bond conditioned for the repayment or payment of money is given in a penal sum greater than the debt secured, the tax shall be based upon the amount secured.

2. Capital stock, issued: On each original issue, whether on organization or reorganization, of certificates of stock, or of profits, or of interest in property or accumulations, by any corporation, on each $100 of face value or fraction thereof, 5 cents: *Provided*, That where a certificate is issued without face value, the tax shall be 5 cents per share, unless the actual value is in excess of $100 per share, in which case the tax shall be 5 cents on each $100 of actual value or fraction thereof, or unless the actual value is less than $100 per share, in which case the tax shall be 1 cent on each $20 of actual value, or fraction thereof.

The stamps representing the tax imposed by this subdivision shall be attached to the stock books and not to the certificates issued.

3. Capital stock, sales or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates, whether made upon or shown by the books of the corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock, interest, or rights, or not, on each $100 of face value or fraction thereof, 2 cents, and where such shares are without par or face value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share: *Provided*, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited, nor upon mere loans of stock nor upon the return of stock so loaned: *Provided further*, That the tax shall not be imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broken to a customer for whom and upon whose order he has purchased same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts: *Provided further*, That in case of sale where the evidence of transfer is

shown only by the books of the corporation the stamp shall be placed upon such books; and where the change of ownership is by transfer of the certificate the stamp shall be placed upon the certificate; and in cases of an agreement to sell or where the transfer is by delivery of the certificate assigned in blank there shall be made and delivered by the seller to the buyer a bill or memorandum of such sale, to which the stamp shall be affixed; and every bill or memorandum of sale or agreement to sell before mentioned shall show the date thereof, the name of the seller, the amount of the sale, and the matter or thing to which it refers. Any person liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person, who makes any such sale, or who in pursuance of any such sale delivers any certificate or evidence of the sale of any stock, interest or right, or bill or memorandum thereof, as herein required, without having the proper stamps affixed thereto with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000, or be imprisoned not more than six months, or both.

4. Produce, sales of, on exchange: Upon each sale, agreement of sale, or agreement to sell (not including so-called transferred or scratch sales), any products or merchandise at, or under the rules or usages of, any exchange, or board of trade, or other similar place, for future delivery, for each $100 in value of the merchandise covered by said sale or agreement of sale or agreement to sell, 2 cents, and for each additional $100 or fractional part thereof in excess of $100, 2 cents: *Provided*, That on every sale or agreement of sale or agreement to sell as aforesaid there shall be made and delivered by the seller to the buyer a bill, memorandum, agreement, or other evidence of such sale, agreement of sale, or agreement to sell, to which there shall be affixed a lawful stamp or stamps in value equal to the amount of the tax on such sale: *Provided further*, That sellers of commodities described herein, having paid the tax provided by this subdivision, may transfer such contracts to a clearing-house corporation or association, and such transfer shall not be deemed to be a sale, or agreement of sale, or an agreement to sell within the provisions of this Act, provided that such transfer shall not vest any beneficial interest in such clearing-house association but shall be made for the sole purpose of enabling such clearing-house association to adjust and balance the accounts of the members of such clearing-house association on their several contracts. Every such bill, memorandum, or other evidence of sale or agreement to sell shall show the date thereof, the name of the seller, the amount of the sale, and the matter or thing to which it refers; and any person liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person, who makes any such sale or agreement of sale, or agreement to sell, or who, in pursuance of any such sale, agreement of sale, or agreement to sell, delivers any such products or merchandise without a bill, memorandum, or other evidence thereof as herein required, or who delivers such bill, memorandum, or other evidence of sale, or agreement to sell, without having the proper stamps affixed thereto, with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000 or be imprisoned not more than six months, or both.

No bill, memorandum, agreement, or other evidence of such sale, or agreement of sale, or agreement to sell, in case of cash sales of products

or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered shall be subject to this tax.

This subdivision shall not affect but shall be in addition to the provisions of the "United States Cotton Futures Act," approved August 11, 1916, as amended, and "The Future Trading Act," approved August 24, 1921.

5. Drafts or checks (payable otherwise than at sight or on demand) upon their acceptance or delivery within the United States whichever is prior, promissory notes, except bank notes issued for circulation, and for each renewal of the same, for a sum not exceeding $100, 2 cents; and for each additional $100, or fractional part thereof, 2 cents.

This subdivision shall not apply to a promissory note secured by the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is secured by the pledge of such bonds or obligations: *Provided*, That in either case the par value of such bonds or obligations shall be not less than the amount of such note.

6. Conveyances: Deed, instrument, or writing, whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons, by his, her, or their direction, when the consideration or value of the interest or property conveyed, exclusive of the value of any lien or encumbrance remaining thereon at the time of sale, exceeds $100 and does not exceed $500, 50 cents; and for each additional $500 or fractional part thereof, 50 cents. This subdivision shall not apply to any instrument or writing given to secure a debt.

7. Entry of any goods, wares, or merchandise at any customhouse, either for consumption or warehousing, not exceeding $100 in value, 25 cents; exceeding $100 and not exceeding $500 in value, 50 cents; exceeding $500 in value, $1.

8. Entry for the withdrawal of any goods or merchandise from customs bonded warehouse, 50 cents.

9. Passage ticket, one way or round trip, for each passenger, sold or issued in the United States for passage by any vessel to a port or place not in the United States, Canada, or Mexico, if costing not exceeding $30, $1; costing more than $30 and not exceeding $60, $3; costing more than $60, $5. This subdivision shall not apply to passage tickets costing $10 or less.

10. Proxy for voting at any election for officers, or meeting for the transaction of business, of any corporation, except religious, educational, charitable, fraternal, or literary societies, or public cemeteries, 10 cents.

11. Power of attorney granting authority to do or perform some act for or in behalf of the grantor, which authority is not otherwise vested in the grantee, 25 cents. This subdivision shall not apply to any papers necessary to be used for the collection of claims from the United States or from any state for pensions, back pay, bounty, or for property lost in the military or naval service, nor to powers of attorney required in bankruptcy cases nor to powers of attorney contained in the application of those who become members of or policyholders in mutual insurance companies doing business on the inter-insurance or reciprocal indemnity plan through an attorney in fact.

12. Playing cards: Upon every pack of playing cards containing not more than fifty-four cards, manufactured or imported, and sold, or removed for consumption or sale, a tax of 8 cents per pack.

13. On each policy of insurance, or certificate, binder, covering note, memorandum, cablegram, letter, or other instrument by whatever name called whereby insurance is made or renewed upon property within the United States (including rents and profits) against peril by sea or on inland waters or in transit on land (including trans-shipments and storage at termini or way points) or by fire, lightning, tornado, wind-storm, bombardment, invasion, insurrection or riot, issued to or for or in the name of a domestic corporation or partnership or an individual resident of the United States by any foreign corporation or partnership or any individual not a resident of the United States, when such policy or other instrument is not signed or countersigned by an officer or agent of the insurer in a state, territory, or district of the United States within which such insurer is authorized to do business, a tax of 3 cents on each dollar, or fractional part thereof of the premium charged: *Provided*, That policies of reinsurance shall be exempt from the tax imposed by this subdivision.

Any person to or for whom or in whose name any such policy or other instrument is issued, or any solicitor or broker acting for or on behalf of such person in the procurement of any such policy or other instrument, shall affix the proper stamps to such policy or other instrument, and for failure to affix such stamps with intent to evade the tax shall, in addition to other penalties provided therefor, pay a fine of double the amount of the tax.

TITLE XII—TAX ON EMPLOYMENT OF CHILD LABOR

Sec. 1200. That every person (other than a bona fide boys' or girls' canning club recognized by the agricultural department of a state and of the United States) operating (a) any mine or quarry situated in the United States in which children under the age of sixteen years have been employed or permitted to work during any portion of the taxable year; or (b) any mill, cannery, workshop, factory, or manufacturing establishment situated in the United States in which children under the age of fourteen years have been employed or permitted to work, or children between the ages of fourteen and sixteen have been employed or permitted to work more than eight hours in any day or more than six days in any week, or after the hour of seven o'clock post meridian, or before the hour of six o'clock ante meridian, during any portion of the taxable year, shall pay for each taxable year, in addition to all other taxes imposed by law (but in lieu of the tax imposed by section 1200 of the Revenue Act of 1918), an excise tax equivalent to 10 per centum of the entire net profits received or accrued for such year from the sale or disposition of the product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment.

Sec. 1201. That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such products manufactured within the United States the following items:

(a) The cost of raw materials entering into the production;

(b) Running expenses, including rentals, cost of repairs, and maintenance, heat, power, insurance, management, and a resonable allowance for salaries or other compensations for personal services actually rendered, and for depreciation;

(c) Interest paid within the taxable year on debts or loans contracted to meet the needs of the business, and the proceeds of which have been actually used to meet such needs;

(d) Taxes of all kinds paid during the taxable year with respect to the business or property relating to the production; and

(e) Losses actually sustained within the taxable year in connection with the business of producing such products, including losses from fire, flood, storm, or other casualties, and not compensated for by insurance or otherwise.

Sec. 1202. That if any such person during any taxable year or part thereof, whether under any agreement, arrangement, or understanding or otherwise, sells or disposes of any product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment at less than the fair market price obtainable therefor either (a) in such manner as directly or indirectly to benefit such person or any person directly or indirectly interested in the business of such person; or (b) with intent to cause such benefit; the gross amount received or accrued for such year or part thereof from the sale or disposition of such product shall be taken to be the amount which would have been received or accrued from the sale or disposition of such product if sold at the fair market price.

Sec. 1203. (a) That no person subject to the provisions of this title shall be liable for the tax herein imposed if the only employment or permission to work which but for this section would subject him to the tax has been of a child as to whom such person has in good faith procured at the time of employing such child or permitting him to work, and has since in good faith relied upon and kept on file a certificate, issued in such form, under such conditions and by such persons as may be prescribed by a board consisting of the Secretary, the Commissioner, and the Secretary of Labor, showing the child to be of such age as not to subject such person to the tax imposed by this title. Any person who knowingly makes a false statement or presents false evidence in or in relation to any such certificate or application therefor shall be punished by a fine of not less than $100, nor more than $1,000, or by imprisonment for not more than three months, or by both such fine and imprisonment, in the discretion of the court.

In any state designated by such board an employment certificate or other similar paper as to the age of the child, issued under the laws of that state, and not inconsistent with the provisions of this title, shall have the same force and effect as a certificate herein provided for.

(b) The tax imposed by this title shall not be imposed in the case of any person who proves to the satisfaction of the Secretary that the only employment or permission to work which but for this section would subject him to the tax, has been of a child employed or permitted to work under a mistake of fact as to the age of such child, and without intention to evade the tax.

Sec. 1204. That on or before the first day of the third month following the close of each taxable year, a true and accurate return under oath shall be made by each person subject to the provisions of this title to the collector for the district in which such person has his principal office or place of business, in such form as the Commissioner, with the approval of the Secretary, shall prescribe, setting forth specifically the gross amount of income received or accrued during such year from the sale or disposition of the product of any mine, quarry, mill, cannery, workshop, fac-

tory, or manufacturing establishment, in which children have been employed subjecting him to the tax imposed by this title, and from the total thereof deducting the aggregate items of allowance authorized by this title, and such other particulars as to the gross receipts and items of allowance authorized by this title, and such other particulars as to the gross receipts and items of allowance as the Commissioner, with the approval of the Secretary, may require.

Sec. 1205. That all such returns shall be transmitted forthwith by the collector to the Commissioner, who shall, as soon as practicable, assess the tax found due and notify the person making such return of the amount of tax for which such person is liable, and such person shall pay the tax to the collector on or before thirty days from the date of such notice.

Sec. 1206. That for the purposes of this Act the Commissioner, or any person duly authorized by him, shall have authority to enter and inspect at any time any mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment. The Secretary of Labor, or any person duly authorized by him, shall, for the purpose of complying with a request of the Commissioner to make such an inspection, have like authority, and shall make report to the Commissioner of inspections made under such authority in such form as may be prescribed by the Commissioner with the approval of the Secretary of the Treasury.

Any person who refuses or obstructs entry or inspection authorized by this section shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both.

Sec. 1207. That as used in this title the term "taxable year" shall have the same meaning as provided for the purposes of income tax in section 200.

TITLE XIII—GENERAL ADMINISTRATIVE PROVISIONS

LAWS MADE APPLICABLE

Sec. 1300. That all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act, and every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns, and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

METHOD OF COLLECTING TAX

Sec. 1301. That whether or not the method of collecting any tax imposed by Titles V, VI, VII, VIII, IX, or X of this Act is specifically provided therein, any such tax may, under regulations prescribed by the Commissioner with the approval of the Secretary, be collected by stamp, coupon, serial-numbered ticket, or such other reasonable device or method as may be necessary or helpful in securing a complete and prompt collection of the tax. All administrative and penalty provisions of Title XI, in so far as applicable, shall apply to the collection of any tax which the Commissioner determines or prescribes shall be collected in such manner.

PENALTIES

Sec. 1302. (a) That any person required under Titles V, VI, VII, VIII, IX, X, or XII, to pay, or to collect, account for and pay over any tax, or required by law or regulations made under authority thereof to make a re-

turn or supply any information for the purposes of the computation, assessment, or collection of any such tax, who fails to pay, collect, or truly account for and pay over any such tax, make any such return or supply any such information at the time or times required by law or regulation shall in addition to other penalties provided by law be subject to a penalty of not more than $1,000.

(b) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax, make such return or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax, shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

(c) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax shall in addition to other penalties provided by law be liable to a penalty of the amount of the tax evaded, or not paid, collected, or accounted for and paid over, to be assessed and collected in the same manner as taxes are assessed and collected: *Provided, however*, That no penalty shall be assessed under this subdivision for any offense for which a penalty may be assessed under authority of section 3176 of the Revised Statutes, as amended, or for any offense for which a penalty has been recovered under section 3256 of the Revised Statutes.

(d) The term "person" as used in this section includes an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

RULES AND REGULATIONS

Sec. 1303. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

The Commissioner, with such approval may by regulation provide that any return required by Titles V, VI, VII, VIII, IX, or X to be under oath may, if the amount of the tax covered thereby is not in excess of $10, be signed or acknowledged before two witnesses instead of under oath.

OVERPAYMENTS AND OVERCOLLECTIONS

Sec. 1304. That in the case of any overpayment or overcollection of any tax imposed by section 602 or by Title V, Title VIII, or Title IX, the person making such overpayment or overcollection may take credit therefor against taxes due upon any monthly return, and shall make refund of any excessive amount collected by him upon proper application by the person entitled thereto.

FRACTIONAL PARTS OF A CENT

Sec. 1306. That in the payment of any tax under this Act not payable by stamp a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

RETURNS

Sec. 1307. That whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a re-

turn or such statements as he deems sufficient to show whether or not such person is liable to tax.

EXAMINATION OF BOOKS AND WITNESSES

Sec. 1308. That the Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

UNNECESSARY EXAMINATIONS

Sec. 1309. That no taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

JURISDICTION OF COURTS

Sec. 1310. (a) That if any person is summoned under this Act to appear, to testify, or to produce books, papers or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions.

(c) Paragraph twentieth of section 24 of the Judicial Code is amended by adding at the end thereof the following new paragraph:

"Concurrent with the Court of Claims, of any suit or proceeding, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected, under the internal-revenue laws, even if the claim exceeds $10,000, if the collector of internal-revenue by whom such tax, penalty, or sum was collected is dead at the time such suit or proceeding is commenced."

AMENDMENTS TO REVISED STATUTES

Sec. 1311. That sections 3164, 3165, 3167, 3172, 3173, and 3176 of the Revised Statutes, as amended, are re-enacted, without change, as follows:

"Sec. 3164. It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

"Sec. 3165. Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

"Sec. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

"Sec. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.

"Sec. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: *Provided,* That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, article or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return re-

quired by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return, which, being distinctly read, consented to, and signed and verified by oath by the person so owning, possessing, or having the care and management as aforesaid, may be received as the list of such person: *Provided further*, That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or a deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest post-office, a note or memorandum addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized government officer to examine the books of such person, firm, or corporation, it shall be lawful for the collector to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person or any other person he may deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the state or territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such state or territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned: *Provided*, That 'person,' as used in this section, shall be construed to include any corporation, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

"Sec. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

FINAL DETERMINATIONS AND ASSESSMENTS

Sec. 1312. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

ADMINISTRATIVE REVIEW

Sec. 1313. That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States.

RETROACTIVE REGULATIONS

Sec. 1314. That in case a regulation or treasury decision relating to the internal revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

REFUNDS

Sec. 1315. That section 3220 of the Revised Statutes, as amended, is re-enacted without change, as follows:

"Sec. 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

Sec. 1316. That section 3228 of the Revised Statutes is amended to read as follows:

"Sec. 3228. All claims for the refunding or crediting of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty, or sum."

This section, except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.

Sec. 1317. That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921, and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal revenue laws.

LIMITATIONS UPON SUITS AND PROSECUTIONS

Sec. 1318. That section 3226 of the Revised Statutes is amended to read as follows:

"Sec. 3226. No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof. No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that time, nor after the expiration of five years from the date of the payment of such tax, penalty, or sum."

This section shall not affect any suit or proceeding instituted prior to the passage of this Act, but shall apply to all suits and proceedings in-

stituted after the passage of this Act, whether or not barred by prior Acts of Congress.

Sec. 1319. That section 3227 of the Revised Statutes is hereby repealed but such repeal shall not affect any suit or proceeding instituted prior to the passage of this Act.

Sec. 1320. That no suit or proceeding for the collection of any internal revenue tax shall be begun after the expiration of five years from the time such tax was due, except in the case of fraud with intent to evade tax, or willful attempt in any manner to defeat or evade tax. This section shall not apply to suits or proceedings for the collection of taxes under section 250 of this Act, nor to suits or proceedings begun at the time of the passage of this Act.

Sec. 1321. (a) That the Act entitled "An Act to limit the time within which prosecutions may be instituted against persons charged with violating internal-revenue laws," approved July 5, 1884, is amended to read as follows:

"That no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal-revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense: *Provided*, That the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings: *Provided further*, That the provisions of this Act shall not apply to offenses committed prior to its passage: *Provided further*, That where a complaint shall be instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district: *And provided further*, That this Act shall not apply to offenses committed by officers of the United States."

(b) Any prosecution or proceeding under an indictment found or information instituted prior to the passage of this Act shall not be affected in any manner by this amendment, but such prosecution or proceeding shall be subject to the limitations imposed by law prior to the passage of this Act.

ASSESSMENTS

Sec. 1322. That all internal revenue taxes, except as provided in section 250 of this Act, shall, notwithstanding the provisions of section 3182 of the Revised Statutes or any other provision of law, be assessed within four years after such taxes became due, but in the case of fraud with intent to evade tax or willful attempt in any manner to defeat or evade tax, such tax may be assessed at any time.

FRAUDULENT RETURNS

Sec. 1323. That section 3225 of the Revised Statutes of the United States, as amended, is re-enacted without change as follows:

"Sec. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, un-

less it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation."

INTEREST ON REFUNDS AND JUDGMENTS

Sec. 1324. (a) That upon the allowance of a claim for the refund of or credit for internal revenue taxes paid, interest shall be allowed and paid upon the total amount of such refund or credit at the rate of one-half of 1 per centum per month to the date of such allowance, as follows: (1) if such amount was paid under a specific protest setting forth in detail the basis of and reasons for such protest, from the time when such tax was paid, or (2) if such amount was not paid under protest but pursuant to an additional assessment, from the time such additional assessment was paid, or (3) if no protest was made and the tax was not paid pursuant to an additional assessment, from six months after the date of filing of such claim for refund or credit. The term "additional assessment" as used in this section means a further assessment for a tax of the same character previously paid in part.

(b) Section 177 of the Judicial Code is amended to read as follows:

"Sec. 177. No interest shall be allowed on any claim up to the time of the rendition of judgment by the Court of Claims, unless upon a contract expressly stipulating for the payment of interest, except that interest may be allowed in any judgment of any court rendered after the passage of the Revenue Act of 1921 against the United States for any internal-revenue tax erroneously or illegally assessed or collected, or for any penalty collected without authority or any sum which was excessive or in any manner wrongfully collected, under the internal-revenue laws."

PAYMENT OF TAXES BY CHECK OR UNITED STATES SECURITIES

Sec. 1325. That collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the Secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

TAX SIMPLIFICATION BOARD

Sec. 1327. (a) That there is hereby established in the department of the treasury a board to be known as the "Tax Simplification Board" (hereinafter in this section called the "Board"), to be composed as follows:

(1) Three members who shall represent the public, to be appointed by the President; and

(2) Three members who shall represent the Bureau of Internal Revenue and shall be officers or employees of the United States serving in such bureau, to be appointed by the Secretary.

(b) Any vacancy in the board shall be filled in the same manner as the original appointment. The members representing the public shall serve without compensation except reimbursement for traveling, subsistence, and other necessary expenses incurred in the performance of the duties vested in them by this section. The members representing the Bureau of Internal Revenue shall serve without compensation in addition to that received for their service in such bureau.

(c) The Secretary shall furnish the board with such clerical assistance, quarters and stationery, furniture, office equipment, and other supplies as may be necessary for the performance of the duties vested in them by this section.

(d) It shall be the duty of the board to investigate the procedure of and the forms used by the bureau in the administration of the internal revenue laws, and to make recommendations in respect to the simplification thereof. The board shall make a report to the Congress on or before the first Monday of December in each year.

(e) The expenditures of the board shall be paid upon vouchers approved by the board and signed by the chairman thereof. For the expenditures of the board for the fiscal year ending June 30, 1922, there is authorized to be appropriated, out of any money in the treasury not otherwise appropriated, the sum of $10,000.

(f) The board shall cease to exist on December 31, 1924.

CONSOLIDATION OF LIBERTY BOND TAX EXEMPTIONS

Sec. 1328. That the various Acts authorizing the issues of Liberty bonds are amended and supplemented as follows:

(a) On and after January 1, 1921, 4 per centum and 4¼ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations, or associations, in respect to the interest on aggregate principal amounts thereof as follows:

Until the expiration of two years after the date of the termination of the war between the United States and the German government, as fixed by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of section 1 of the supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of section 1 of the supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act.

DEPOSIT OF UNITED STATES BONDS OR NOTES IN LIEU OF SURETY

Sec. 1329. That wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking, hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds or notes of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds or notes so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds or notes in lieu of surety or sureties required by law shall have the same force and effect as individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the

penalty or amount of such penal bond. The bonds or notes deposited hereunder and such other United States bonds or notes as may be substituted therefor from time to time as such security, may be deposited with the Treasurer of the United States, a federal reserve bank, or other depositary duly designated for that purpose by the Secretary, which shall issue receipt therefor, describing such bonds or notes so deposited. As soon as security for the performance of such penal bond is no longer necessary, such bonds or notes so deposited, shall be returned to the depositor: *Provided*, That in case a person or persons supplying a contractor with labor or material as provided by the Act of Congress, approved February 24, 1905 (33 Stat. 811), entitled "An Act to amend an Act approved August thirteenth, eighteen hundred and ninety-four, entitled 'An act for the protection of persons furnishing materials and labor for the construction of public works,'" shall file with the obligee, at any time after a default in the performance of any contract subject to said Acts, the application and affidavit therein provided, the obligee shall not deliver to the obligor the deposited bonds or notes nor any surplus proceeds thereof until the expiration of the time limited by said Acts for the institution of suit by such person or persons, and, in case suit shall be instituted within such time, shall hold said bonds or notes or proceeds subject to the order of the court having jurisdiction thereof: *Provided further*, That nothing herein contained shall affect or impair the priority of the claim of the United States against the bonds or notes deposited or any right or remedy granted by said Acts or by this section to the United States for default upon any obligation of said penal bond: *Provided further*, That all laws inconsistent with this section are hereby so modified as to conform to the provisions hereof: *And provided further*, That nothing contained herein shall affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The Secretary may prescribe rules and regulations necessary and proper for carrying this section into effect.

CONSOLIDATED RETURNS FOR YEAR 1917

Sec. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of

net income or invested capital. For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

ALTERNATIVE TAX ON PERSONAL SERVICE CORPORATIONS

Sec. 1332. (a) That if either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is by final adjudication declared invalid, there shall, in addition to all other taxes, be levied, collected, and paid on the net income (as defined in section 232) received during the calendar years 1918, 1919, 1920, and 1921, by every personal service corporation (as defined in section 200) included within the provisions of such subdivisions, a tax equal to the taxes imposed by Titles II and III of the Revenue Act of 1918 and, in the case of income received during the calendar year 1921, by Titles II and III of this Act.

(b) In such event every such personal service corporation shall, on or before the fifteenth day of the sixth month following the date of entry of decree upon such final adjudication, make a return of any income received during each of the calendar years 1918, 1919, 1920, and 1921 in the manner prescribed by the Revenue Act of 1918 (or in the manner prescribed by this Act, in the case of income received during the calendar year 1921). Such return shall be made and the net income shall be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in the manner provided for other corporations under the Revenue Act of 1918 and this Act.

(c) If either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is so declared invalid, claims for credit or refund of taxes paid under both such sections shall be allowed, if made within the time provided in subdivision (f) of this section.

(d) In case the claims for credit or refund, filed within six months from such date of entry of decree, represent less than 30 per centum of the outstanding stock or shares in the corporation, the amount of taxes imposed by this section upon such corporation shall be reduced to that proportion thereof which the number of stock or shares owned by the shareholders or members making such claims bears to the total number of stock or shares outstanding.

(e) The tax imposed by this section shall be assessed, collected, and paid upon the same basis, in the same manner, and subject to the same provisions of law, including penalties, as the taxes imposed by sections 230 and 301 of the Revenue Act of 1918 (or by sections 230 and 301 of this Act, in the case of income received during the calendar year 1921), but no interest or penalties shall be due or payable thereon for any period prior to the date upon which the return is by this section required to be made and the first installment paid. The amount of tax paid by any shareholder or member of a personal service corporation pursuant to the provisions of subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act shall be credited against the tax due from

such corporation under this section upon the joint written application of such corporation and such shareholder or member or his representatives, heirs, or assigns, if such application is filed with the Commissioner within six months from such date of entry of decree.

(f) Notwithstanding any other provision of law, no claim for a credit or refund of taxes paid under subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act, may be filed after the expiration of six months from such date of entry of decree: *Provided, however*, That a personal service corporation of which no shareholder or member has filed such claim within such period of six months shall not be subject to the tax imposed by this section.

TITLE XIV—GENERAL PROVISIONS

REPEALS

Sec. 1400. (a) That the following parts of the Revenue Act of 1918 are repealed, to take effect (except as otherwise provided in this Act) on January 1, 1922, subject to the limitations provided in subdivision (b):

Title II (called "Income Tax") as of January 1, 1921:

Title III (called "War-Profits and Excess-Profits Tax") as of January 1, 1921;

Title IV (called "Estate Tax") on the passage of this Act;

Title V (called "Tax on Transportation and Other Facilities, and on Insurance");

Sections 628, 629, and 630 of Title VI (being the taxes on soft drinks, ice cream, and similar articles);

Title VII (called "Tax on Cigars, Tobacco and Manufactures Thereof");

Title VIII (called "Tax on Admissions and Dues");

Title IX (called "Excise Taxes");

Title X (called "Special Taxes");

Title XI (called "Stamp Taxes");

Title XII (called "Tax on Employment of Child Labor") as of January 1, 1921; and

Sections 1314, 1315, 1316, 1317, 1319, and 1320 of Title XIII (being certain administrative provisions) on the passage of this Act.

(b) The parts of the Revenue Act of 1918 which are repealed by this Act shall (unless otherwise specifically provided in this Act) remain in force for the assessment and collection of all taxes which have accrued under the Revenue Act of 1918 at the time such parts cease to be in effect, and for the imposition and collection of all penalties or forfeitures which have accrued or may accrue in relation to any such taxes. In the case of any tax imposed by any part of the Revenue Act of 1918 repealed by this Act, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under this Act takes effect under the provisions of this Act. The unexpended balance of any appropriation heretofore made and now available for the administration of any such part of the Revenue Act of 1918 shall be available for the administration of this Act or the corresponding provision thereof.

SAVING CLAUSE IN EVENT OF UNCONSTITUTIONALITY

Sec. 1403. That if any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of the Act, and the application of such provision to other persons or circumstances, shall not be affected thereby.

EFFECTIVE DATE OF ACT

Sec. 1404. That except as otherwise provided, this Act shall take effect upon its passage.

Approved, November 23, 1921, at 3:55 p. m.

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